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No. 00-

IN THE

Supreme Court of the United States

SALLY FRAME KASAKS, PAUL E. FRANCIS, JOSEPH R. GROMEK, ANNTAYLOR STORES CORPORATION and ANNTAYLOR, INC.,

Petitioners,

v.

CAROL NOVAK, ROBERT NEIMAN and JOSEPH DESENA, on behalf of themselves and all others similarly situated,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

In 1995, Congress passed the Private Securities Litigation Reform Act of 1995 (the "PSLRA") to create a uniform pleading standard for securities fraud class actions more stringent than the varying standards previously applied by the United States Courts of Appeals under Federal Rule of Civil Procedure 9(b) ("Rule 9(b)"). A complaint not meeting the pleading standard must, according to Congress, be dismissed. The courts of appeals, however, have interpreted the pleading requirements of the PSLRA in irreconcilably divergent manners, with the practical consequence that securities class action complaints that would be dismissed in one jurisdiction will be permitted to stand in others. Review of this case by the Court will resolve this conflict among the courts of appeals (which these courts have acknowledged), and implement the PSLRA's objective that there be a uniform pleading standard in all future securities fraud actions. The issues presented for review are:

1. Whether the PSLRA's requirement that a securities fraud plaintiff "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind," 15 U.S.C. § 78u-4(b)(2), imposes a uniform standard for pleading intent more stringent than those previously applied by the courts of appeals under Rule 9(b), as the majority of circuit courts to consider this question has held, or demands only that a plaintiff meet the more lenient Rule 9(b) standard applied by the Second Circuit before the PSLRA's enactment, as held by the court below and by the Third Circuit.

2. Whether a putative securities class action plaintiff alleging, on information and belief, violation of the federal securities laws must "state with particularity *all* facts on which that belief is formed," 15 U.S.C. § 78u-4(b)(1) (emphasis added), as required by the terms of the PSLRA and the Ninth Circuit, or merely certain facts purportedly "sufficient" to comply with the requirements of Rule 9(b) as construed by the United States Courts of Appeals prior to enactment of the PSLRA and as adhered to by the Second Circuit below.

PARTIES TO THE PROCEEDING BELOW

The parties to the proceeding below were petitioners Sally Frame Kasaks, Paul E. Francis, Joseph R. Gromek, AnnTaylor Stores Corporation and AnnTaylor, Inc.; respondents Carol Novak, Robert Neiman and Joseph Desena, purporting to act on behalf of themselves and a class of all others similarly situated; and Merrill Lynch & Company, Merrill Lynch, Pierce Fenner & Smith Inc., Merrill Lynch Capital Partners, Inc., ML IBK Positions, Inc., Merchant Banking L.P. No. III, Kecalp, Inc., Gerald S. Armstrong and James J. Burke, defendants-appellees, who entered into a settlement agreement with respondents and have been dismissed from this action.

STATEMENT PURSUANT TO RULE 29.6

Petitioner AnnTaylor, Inc. is wholly owned by petitioner AnnTaylor Stores Corporation, which has no parent corporation. No publicly held company owns 10 percent or more of the stock of petitioner AnnTaylor Stores Corporation.

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Petitioners Sally Frame Kasaks, Paul E. Francis, Joseph R. Gromek, AnnTaylor Stores Corporation and AnnTaylor, Inc. respectfully request that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit in this action entered on June 21, 2000.

OPINIONS BELOW

Review is sought of a decision of the United States Court of Appeals for the Second Circuit, issued on June 21, 2000. The Second Circuit's opinion is reported at 216 F.3d 300 (2d Cir. 2000). The decision of the United States District Court for the Southern District of New York dismissing respondents' amended complaint, issued November 12, 1998, is reported at 26 F. Supp. 2d 658 (S.D.N.Y. 1998). The decision of the District Court dismissing respondents' original complaint, issued March 10, 1998, is reported at 997 F. Supp. 425 (S.D.N.Y. 1998). Copies of these opinions are attached as an Appendix to this petition.

STATEMENT OF JURISDICTION

The judgment of the United States Court of Appeals was entered on June 21, 2000. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

This case involves provisions of Section 21D of the Securities Exchange Act of 1934, 15 U.S.C. § 78u-4, which was enacted by the PSLRA. Section 21D provides, in relevant part:

> (b) *Requirements For Securities Fraud Actions.*
>
> (1) *Misleading Statements and Omissions.* In any private action arising under this chapter in which the plaintiff alleges that the defendant: (A) Made an untrue statement of material fact; or (B) Omitted to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading; the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.
>
> (2) *Required state of mind.* In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

(3) *Motion to Dismiss; Stay of Discovery.* (A) *Dismissal For Failure to Meet Pleading Requirements.* In any private action arising under this chapter, the court shall, on the motion of any defendant, dismiss the complaint if the requirments of paragraphs (1) and (2) are not met.

STATEMENT OF THE CASE

The amended complaint is brought on behalf of a class of persons who purchased common stock of Ann Taylor, a retailer of women's apparel, between February 3, 1994 and May 4, 1995. Respondents allege that Ann Taylor and other defendants violated the federal securities laws by making false and misleading statements about the value of Ann Taylor's inventory. The amended complaint focuses on Ann Taylor's practice of storing certain unsold inventory for sale at a later time, typically when it was again in season. The amended complaint refers to this practice as "AnnTaylor's . . . 'Box & Hold' scheme," but alleges only generally that Ann Taylor accumulated "huge" amounts of inventory in Box & Hold and carried this inventory on its books at "full value" even though it was purportedly "worthless," "unsaleable, excess and obsolete." Other than offering these conclusions, however, respondents do not allege specifically why — other than their own say so — they believe the inventory was worthless.

Respondents claimed to base their allegations on review of Ann Taylor's public filings with the Securities and Exchange Commission; press releases and other public statements issued by the defendants; published reports and news articles regarding the company; internal Ann Taylor documents; documents produced by various non-parties in the litigation and communications with certain former unidentified Ann Taylor employees and independent but unnamed consultants.

Ann Taylor and the other defendants moved to dismiss the amended complaint charging that respondents' allegations of both the existence of a fraud and the defendants' fraudulent intent failed to meet the rigorous pleading standards that the PSLRA requires be satisfied before such serious charges may be pursued. The District Court, as it did with the original complaint, dismissed the amended complaint, this time with prejudice, holding that its generalized allegations failed to plead fraudulent intent with particularity, as required by the PSLRA. *See Novak v. Kasaks,* 26 F. Supp. 2d. 658, 660-63 (S.D.N.Y. 1998) ("*Novak II*") (A-32a-43a),[1] *vacated*, 216 F.3d 300 (2d Cir. 2000); *Novak v. Kasaks*, 997 F. Supp. 425, 430-33 (S.D.N.Y. 1998) ("*Novak I*") (A-56a-65a). Specifically, the District Court determined that respondents failed to allege with sufficient specificity that, at the time Ann Taylor made statements about its financial condition and inventory levels, the defendants were aware (or recklessly disregarded) that much of Ann Taylor's inventory was overvalued. *Novak II,* 26 F. Supp. 2d at 661-62 (A-37a-39a); *Novak I*, 997 F. Supp. at 431 (A-58a-60a). This failure resulted directly from respondents' non-compliance with the PSLRA's requirement that they identify with particularity *all* facts supporting their belief that a fraud had been committed, including with respect to what documents had been provided by third parties, what documents respondents had reviewed, what information the documents had contained and the sources of the documents relied upon, as well as the identities of the consultants and anonymous former employees on whom respondents claimed to rely. *See Novak II,* 26 F. Supp. 2d at 661-62 (A-37a-40a); *Novak I*, 997 F. Supp. at 431-32 (A-59a-63a).

The District Court recognized that although respondents' allegations sought to establish that the Box and Hold inventory " 'was nearly worthless,' " respondents offered no

1. "A-__" refers to pages of the Appendix annexed hereto.

more than conclusory statements that this was true, and had not identified any particularized facts to support their "unsupported and inflammatory" claims of fraud. *Novak II*, 26 F. Supp. 2d at 661-62 (A-38a).

The Second Circuit vacated the dismissal of the amended complaint.[2] It rejected the holdings of the majority of courts of appeals that the PSLRA created a new, stringent standard for pleading fraudulent intent in securities fraud cases, and instead concluded that the PSLRA simply codified the Second Circuit's pre-existing standard, adding only a requirement that intent be plead with particularity. *See Novak v. Kasaks*, 216 F.3d 300, 309-11 (2d Cir. 2000) (A-18a-22a). The court then held that the same allegations the District Court found to be wholly conclusory — *i.e.*, that the defendants knew the Box and Hold inventory to be worthless — satisfied the strictures of the PSLRA that intent be plead with specificity. *Id.* at 311-12 (A-23a-24a).

The Second Circuit declared that it could express no conclusion as to whether the allegations of fraud in the amended complaint were sufficiently particularized to meet the PSLRA's mandate that a plaintiff plead specifically all facts on which her belief that a fraud has been committed is based. *See id.* at 314 (A-29a). The Second Circuit did, however, reject the District Court's interpretation of the PSLRA's requirement that a plaintiff plead "all facts" on which her belief is based, holding that "all facts" does not actually mean all facts, but rather merely facts sufficient to satisfy the requirements of Rule 9(b) as applied before passage of the PSLRA. *See* 216 F.3d at 313-14 (A-28a).

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2. The Securities and Exchange Commission participated in the appeal as *amicus curiae*, and argued that proper and uniform interpretation of the PSLRA was a highly important question, because it would have a significant impact on the statute's effectiveness.

Accordingly, the Second Circuit stated that the District Court was incorrect in requiring respondents to identify their purported "confidential" sources, *see id.* at 312-14 (A-26a-29a), and instructed the District Court to permit respondents to file a third complaint and then to assess respondents' compliance with the PSLRA as interpreted by the Second Circuit. *Id.* at 314 (A-29a-30a).

The court did not seek to — and indeed could not, had it attempted to — harmonize its holding that respondents had pled intent to commit fraud with particularity with its inability to determine whether respondents had pled the underlying fraud with particularity. The result of these contradictory holdings is the adoption by the Second Circuit, in square conflict with the PSLRA, of a less stringent standard for pleading scienter than for pleading the existence of an underlying fraud.

REASONS FOR GRANTING THE WRIT

Concerned with its findings of abuse of the federal securities laws by private litigants and the harm caused to the nation's capital markets by this abuse, and disturbed by the inconsistent pleading standards for securities fraud actions developed by the courts of appeals under Rule 9(b), Congress passed the PSLRA to "establish uniform and more stringent pleading requirements to curtail the filing of meritless lawsuits." H.R. Conf. Rep. No. 104-369, at 41 (1995) (the "Conference Report"), *reprinted in* 1995 U.S.C.C.A.N. 730, 740.

In its opinion below, the Second Circuit became the sixth court of appeals to interpret these new pleading requirements, and did so in clear conflict with the decisions of the majority of the courts of appeals, the plain language of the PSLRA and Congress's intent in enacting the statute.

A writ of certiorari should be granted in this action for the following reasons:

First, the decision of the court below is in irreconcilable conflict with the decisions of the First, Sixth, Ninth and Eleventh Circuits as to interpretation of the PSLRA's requirements for pleading fraudulent intent in securities cases, 15 U.S.C. § 78u-4(b)(2). Whereas the First, Sixth, Ninth and Eleventh Circuits held that the PSLRA created a standard more stringent than that extant in any circuit before passage of the statute, the Second Circuit held, consistent with only the Third Circuit, that the PSLRA did no more than adopt the pre-existing Second Circuit standard for pleading scienter. The decision below is not merely in conflict with the decisions of the majority of the courts of appeals, however; it is also in direct conflict with the plain language of the PSLRA itself. The Second Circuit applied its formulation of the PSLRA in such a manner as to write out of the statute the express requirement that fraudulent intent be plead "with particularity." *See* Point I, *infra*.

Second, the Second Circuit's decision rejects the plain language of the PSLRA requiring that any securities fraud complaint pled on information and belief "*shall* state with particularity *all* facts on which that belief is formed," 15 U.S.C. § 78u-4(b)(1) (emphasis added), by holding that a plaintiff need not plead all facts on which her belief that a fraud has been committed is based. This holding not only violates fundamental tenets of statutory construction, but also conflicts directly with decision of the Ninth Circuit, the only other appellate court to interpret the "all facts" language of § 78u-4(b)(1). *See In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 983-85 (9th Cir. 1999). *See* Point II, *infra*.

Third, effectuating congressional intent to establish a uniform pleading standard by which all complaints may be measured is a goal that can only be achieved through

certiorari review. Securities class action lawsuits occupy a significant portion of the dockets of the federal courts; indeed, they accounted for more than 35 percent of all class actions pending before the federal courts in 1999. *See* Leonidas Ralph Mecham, *Judicial Business of the United States Courts: 1999 Annual Report of the Director* 389-96 (1999) (Tables X-4 and X-5). The filing of class actions alleging securities fraud has risen substantially since Congress enacted the PSLRA. In 1998, 29 percent of total pending class actions and 31 percent of class actions commenced in the federal district courts were securities class actions. *See* Leonidas Ralph Mecham, *Judicial Business of the United States Courts: 1998 Annual Report of the Director* 398-404 (1998) (Tables X-4 and X-5). And in 1997, securities class action lawsuits made up only 21 percent of total pending class actions and 18 percent of class actions commenced in the federal district courts. *See* Leonidas Ralph Mecham, *Judicial Business of the United States Courts: 1997 Annual Report of the Director* 383-88 (1997) (Tables X-4 and X-5).

Given the increasing importance of securities class action lawsuits in the federal courts, it is vital that Congress's intent to create a uniform pleading standard through the PSLRA — application of which will obviously be outcome determinative in many cases — be realized. If the courts of appeals continue to apply varying standards, plaintiffs will be encouraged to seek out the most lenient jurisdictions in which to file these cases, and the PSLRA will effectively be rendered a nullity.

I.

THE SECOND CIRCUIT'S INTERPRETATION OF THE REQUIREMENTS FOR PLEADING FRAUDULENT INTENT IRRECONCILABLY CONFLICTS WITH DECISIONS OF THE FIRST, SIXTH, NINTH AND ELEVENTH CIRCUITS, WITH THE INTENT OF CONGRESS IN PASSING THE PSLRA AND WITH THE UNAMBIGUOUS LANGUAGE OF THE PSLRA ITSELF

Prior to the Second Circuit's decision in this case, the courts of appeals for five other circuits addressed the proper interpretation of the PSLRA's requirement that a securities fraud complaint "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). Although Congress had stated that this was intended to create a uniform pleading standard more stringent than that applied by the courts of appeals under Rule 9(b), the decisions of the courts of appeals — which centered principally on whether Congress codified the Rule 9(b) standard extant in the Second Circuit prior to the PSLRA or elevated this standard — have been far from uniform.

The Third Circuit held — as did the Second Circuit below — that the PSLRA adopted the Second Circuit's pre-existing Rule 9(b) standard. *See In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 533-35 (3d Cir. 1999); *Novak*, 216 F.3d at 309-11 (A-18a-23a). These courts thus construe the PSLRA to permit plaintiffs to allege securities fraud either by pleading that a defendant had a motive and opportunity to commit fraud or by pleading strong circumstantial evidence of recklessness or conscious wrongdoing, with the addition only of the requirement that intent be plead with particularity.[3] *See Novak*, 216 F.3d at

3. As discussed below, although the Second Circuit paid lip service to the "with particularity" language of § 78u-4(b)(2), it read this requirement out of the statute through the manner in which it applied its formulation of the PSLRA's pleading requirement.

309-10 (A-17a-21a); *Advanta*, 180 F.3d at 534-35. As the Second Circuit recognized, *see* 216 F.3d at 310 (A-19a), this holding conflicts with those of the Sixth, Ninth and Eleventh Circuits, each of which held that the PSLRA established a more stringent pleading standard than the pre-existing Second Circuit standard, most particularly by eliminating mere allegations of a motive and opportunity as a basis adequately to plead intent to commit securities fraud. *See In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 549-51 (6th Cir. 1999); *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 974-79 (9th Cir. 1999); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1282-87 (11th Cir. 1999). Additionally, although not addressed in the Second Circuit's decision, the First Circuit interprets § 78u-4(b)(2) in a manner consistent with the Sixth, Ninth and Eleventh Circuits to hold — contrary to the decisions of the Second and Third Circuits — that mere allegations of motive and opportunity do not adequately allege scienter. *See Greebel v. FTP Software, Inc.*, 194 F.3d 185, 194-97 (1st Cir. 1999).

In reaching its decision below, the Second Circuit declared that its review of the text and legislative history of the PSLRA led it to take a "middle ground" between the interpretations of the PSLRA by the Third Circuit, on the one hand, and the Sixth, Ninth and Eleventh, on the other. *See Novak*, 216 F.3d at 310 (A-19a). Noting that Congress failed to include specific language referencing "motive and opportunity" in the PSLRA, the Second Circuit stated that "litigants and lower courts need and should not employ or rely on magic words such as 'motive and opportunity.' " *Id.* at 310-11 (A-19a-22a). Nonetheless, in holding that a securities fraud plaintiff can adequately plead scienter through allegations that a defendant "benefitted in a concrete and personal way from the purported fraud," *id.*, the court relied entirely on its pre-PSLRA motive and opportunity jurisprudence. *See id.* at 307-08 (A-13a-18a). In any event,

any confusion that may have been engendered by this decision regarding the continued viability of allegations of motive and opportunity in the Second Circuit has been conclusively dispelled by a case decided after issuance of the opinion below, in which the Second Circuit — without citation to *Novak* — held explicitly that the PSLRA did not eliminate "the option of pleading scienter by alleging that a defendant had motive and opportunity to commit fraud." *Ganino v. Citizens Utils. Co.*, Docket No. 99-7904, 2000 U.S. App. LEXIS 22493, at *41 (2d Cir. Sept. 6, 2000) (to be published in F.3d).

The sharp division among the courts of appeals, which can only be reconciled by this Court on certiorari review, frustrates a key Congressional objective in passing the PSLRA — the creation of "*uniform* and more stringent pleading requirements to curtail the filing of meritless lawsuits." Conference Report at 41, *reprinted in* 1995 U.S.C.C.A.N. at 740 (emphasis added). Congress's desire to establish a uniform standard for the pleading of scienter in securities fraud class actions was born of its frustration with the fact that "the courts of appeals have interpreted Rule 9(b)'s requirement in conflicting ways, creating distinctly different standards among the circuits." *Id.* If the decision of the Second Circuit below is not reviewed by this Court, passage of the PSLRA will have served no purpose other than to engender a new conflict among circuit courts concerning the appropriate pleading standards in securities fraud cases and will encourage forum shopping by counsel looking for hospitable locales in which to assert their claims. Left unaddressed by this Court, the distinctly different standards that these courts are currently applying under the PSLRA will never be reconciled.

Moreover, the manner in which the PSLRA was interpreted by the Second and Third Circuits is in direct conflict with Congress's unambiguously expressed intent to

"establish . . . *more stringent* pleading requirements" than had been imposed by the courts of appeals under Rule 9(b). Conference Report at 41, *reprinted in* 1995 U.S.C.C.A.N. at 740 (emphasis added). Specifically, Congress declared:

> The Conference Committee language is based *in part* on the pleading standard of the Second Circuit. . . . Regarded as the most stringent pleading standard, the Second Circuit requirement is that the plaintiff state facts with particularity, and that these facts must, in turn, give rise to a "strong inference" of the defendant's fraudulent intent. *Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard.*[23]
>
> * * *
>
> [23] For this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness.

Conference Report at 41 & n.23, *reprinted in* 1995 U.S.C.C.A.N. at 740 & n.23 (emphasis added). By holding that the PSLRA did no more than codify the pre-existing Second Circuit pleading standard, including its reference to motive and opportunity, *see Novak*, 216 F.3d at 310-11 (A-22a); *Advanta*, 180 F.3d at 533-35, the Second and Third Circuits disregarded this clear statement of Congressional intent. In stark contrast, the decisions of the First, Sixth, Ninth and Eleventh Circuits properly gave effect to Congressional intent by holding that the PSLRA imposes a more rigorous pleading standard than applied by any of the courts of appeals before the statute's enactment. *See Greebel*, 194 F.3d at 194-97; *Comshare*, 183 F.3d at 549-51; *Silicon Graphics*, 183 F.3d at 974, 979; *Bryant*, 187 F.3d at 1282-87.

Finally — wholly apart from its conflicts with the decisions of other courts of appeals and with Congressional intent — the Second Circuit's application of § 78u-4(b)(2) below is inconsistent with the language of the PSLRA itself. Section 78u-4(b)(2) requires a securities fraud class action complaint to "state *with particularity* facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (emphasis added). Although the Second Circuit held that the PSLRA simply adopted its own pre-existing scienter pleading standard virtually wholesale, it did purport to recognize that under § 78u-4(b)(2) allegations of intent must now be plead with particularity. *See* 216 F.3d at 310-11 (A-22a). The court's application of this standard below, however, served to write the "with particularity" requirement out of the PSLRA entirely.

By adhering to its pre-existing standard, the Second Circuit held that respondents could adequately plead intent by either alleging facts to show that the defendants had a motive and opportunity to commit fraud or by alleging facts constituting strong circumstantial evidence of conscious misbehavior or recklessness. *See id.* at 307-08 (A-12a-16a). Because respondents did not allege that petitioners had a motive or opportunity to commit fraud, the Second Circuit's conclusion that the amended complaint below satisfied the requirements of the PSLRA was necessarily based on its allegations purporting to demonstrate "strong circumstantial evidence of conscious misbehavior or recklessness." *See id.* at 308-12 (A-14a-26a). These allegations were that petitioners knew Ann Taylor suffered from inventory problems, refused to mark down purportedly "worthless," "obsolete" and "unsalable" inventory, violated Ann Taylor's markdown policy and falsely assured the investment community that inventory levels were under control. *See id.* at 311-12 (A-23a-26a).

By holding these allegations sufficient to plead intent with particularity, however, the Second Circuit applied a lower standard to the pleading of intent than it did to the pleading of an underlying fraud. This conflicts with the plain language of the PSLRA, which requires that *both* an underlying fraud and the intent to commit that fraud be plead "with particularity." *See* 15 U.S.C. § 78u-4(b)(1)-(2). In short, the allegations of circumstantial evidence of recklessness that the Second Circuit deemed sufficient to plead intent with particularity were essentially respondents' allegations of the existence of the alleged fraud. The Second Circuit was unable, however, to express any view on whether these same allegations were sufficiently particularized to satisfy another provision of the PSLRA, 15 U.S.C. § 78u-4(b)(1), which requires a plaintiff making allegations of fraud on information and belief (as do respondents here) to state with particularity all facts on which the belief is based. *See* 216 F.3d at 314 (A-29a-30a).

Significantly, however, the Second Circuit itself recognizes that where a plaintiff seeks to plead intent through allegations of circumstantial evidence of conscious misbehavior or recklessness, the inquiry into whether intent has adequately been pled collapses into the inquiry into whether the allegations of fraud are sufficiently particularized — in other words, the allegations of fraud and intent are virtually one and the same. *See Rothman v. Gregor*, 220 F.3d 81, 90-93 (2d Cir. 2000). In its decision below, however, the Second Circuit did not treat the allegations of intent and fraud as co-existent for one important purpose, *i.e.*, the analysis of whether they were adequately particularized to meet the PSLRA's strictures. Through this failure, it applied a more lenient standard to pleading intent than it did to pleading the underlying fraud, whereas the PSLRA explicitly requires that both be pled with particularity.

As the foregoing discussion reveals, the Second Circuit's interpretation of § 78u-4(b)(2) conflicts with the holdings of the majority of the courts of appeal and with the terms of the statute. These myriad conflicts can only be resolved on certiorari review.

II.

THE SECOND CIRCUIT'S INTERPRETATION OF § 78u-4(b)(1) DIRECTLY CONFLICTS WITH THE PLAIN LANGUAGE OF THE PSLRA AND THE NINTH CIRCUIT'S INTERPRETATION OF THIS PROVISION

The PSLRA is unambiguous in its requirement that when the allegations of a securities fraud complaint are made on information and belief — as are respondents' here — the plaintiff "*shall* state with particularity *all* facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1) (emphasis added). The Second Circuit, however, rejected this statutory provision by ignoring its plain language to hold that "notwithstanding the use of the word 'all,' " the PSLRA does not require that a plaintiff plead all facts on which her belief is based. 216 F.3d at 313-14 (A-26a-29a). The Second Circuit thus contravened a fundamental precept of statutory interpretation established by this Court, *i.e.*, that a statute must be interpreted according to its plain meaning. *See, e.g., Miller v. French*, 120 S. Ct. 2246, 2253 (2000).

Without any reference to the PSLRA's legislative history, the Second Circuit decreed "that Congress cannot have intended" that a plaintiff be required to plead all facts on which her belief that a defendant committed fraud is based. 216 F.3d at 314 n.1 (A-28a n.1). The Second Circuit had no support for its declaration of Congress's intent, however, because Congress itself stated in the Conference Report that the intent of this provision was indeed to require that a "plaintiff . . . state

with particularity *all* facts in the plaintiff's possession on which the belief is formed." Conference Report at 41, *reprinted in* 1995 U.S.C.C.A.N. at 740 (emphasis added). As this Court has noted, a conference report such as the one issued in connection with passage of the PSLRA is a "traditionally . . . authoritative indicator[] of legislative intent." *Northeast Bancorp, Inc. v. Board of Governors of Fed. Reserve Sys.*, 472 U.S. 159, 170 (1985).

A court may only depart from the literal language of a statute in the rare instance that the unambiguous legislative history of the statute is contrary to its plain language. *See Kaiser Aluminum & Chem. Corp. v. Bonjorno*, 494 U.S. 827, 835 (1990). By departing from the plain language of § 78u-4(b)(1) in the face of unambiguous legislative history *wholly consistent* with the statute's literal language, the Second Circuit has turned this Court's jurisprudence on its head and effectively overruled Congress's determination of the proper degree of particularity required for a securities fraud complaint to stand, replacing that determination with a standard of its own making. This is manifestly improper as a matter of law, and as a practical matter will permit the filing and litigation of securities fraud class actions that Congress has decreed are without adequate basis.

To be sure, the Second Circuit sought to justify its departure from the literal language of § 78u-4(b)(1) and Congress's expressly manifested intent with the explanation that to require a plaintiff to plead all facts on which her belief is based "would produce illogical results." 216 F.3d at 314 n.1 (A-28a n.1). The Second Circuit hypothesized that, under the PSLRA's plain meaning, a plaintiff who pled all facts supporting her belief could meet the statute's requirements and therefore have her complaint sustained even if the "facts were patently insufficient to support that belief." *Id.* This simplistic analysis failed entirely to consider, however, that a plaintiff who pleads facts "patently

insufficient" to support a belief that a defendant committed securities fraud has failed to plead a cause of action for securities fraud, thus subjecting her complaint to dismissal under Rule 12(b)(6) of the Federal Rules of Civil Procedure. This result is not at all illogical. Nor is it illogical for the PSLRA to require that a securities fraud plaintiff plead all facts on which her belief is based even where something less might support an inference of fraud in another context. *Cf.* 216 F.3d at 314 n.1 (A-28a n.1). The Second Circuit concluded that pleading something less than all facts on which a belief that a fraud has been committed is based can comport with the requirements of Rule 9(b), and decided that this must be all that Congress intended to require through the PSLRA. *See id.* at 313-14 & n.1 (A-26a-28a & n.1). Again, however, the court's attempt to attribute its own reasoning to Congress is undercut by Congress's own statement of its intent in enacting the PSLRA, which was to impose a "more stringent" requirement than that found in Rule 9(b) because Rule 9(b) "has not prevented abuse of the securities laws by private litigants." Conference Report at 41, *reprinted in* 1995 U.S.C.C.A.N. at 740.

The Second Circuit's conclusion that "all" as used in § 78u-4(b)(1) does not actually mean all is in direct conflict with the decision of the Ninth Circuit in *Silicon Graphics*, which is the only other court of appeals specifically to address this language.[4] In *Silicon Graphics*, the Ninth Circuit adhered to the plain language of the PSLRA and held that § 78u-4(b)(1) "means that a plaintiff must provide, in great detail, *all* the relevant facts forming the basis of her belief."

4. Although it did not specifically address the meaning of the word "all" in the PSLRA, the First Circuit in *Greebel* concluded that § 78u-4(b)(1) codified that circuit's pre-existing Rule 9(b) jurisprudence. *See* 194 F.3d at 193-94. Thus, like the Second Circuit's decision below, the First Circuit's interpretation of this provision also conflicts with the plain language of the PSLRA, Congress' intent in enacting this requirement and the decision of the Ninth Circuit in *Silicon Graphics*.

183 F.3d at 985 (emphasis added). This conflict is not merely academic, and is readily evidenced by the sharply different manner in which the Second and Ninth Circuits addressed the question of whether a plaintiff who seeks to bolster the allegations of a complaint through purported reliance on "confidential sources" must identify these sources in order to comply with § 78u-4(b)(1).

In both this case and *Silicon Graphics*, the plaintiffs claimed to base their belief that a fraud was committed on information obtained from unnamed, unidentified sources, and both complaints were dismissed, in part, for their failure to identify these sources. *Novak II*, 26 F. Supp. 2d at 660-61 (A-35a-37a); *In re Silicon Graphics Inc. Sec. Litig.*, 970 F. Supp. 746, 763, 766-68 (N.D. Cal. 1997), *aff'd*, 183 F.3d 970 (9th Cir. 1999). Because it determined that the PSLRA does not actually require a plaintiff to plead all facts on which her belief that a fraud was committed is based, the Second Circuit held that a plaintiff is not required to identify her purported confidential sources and vacated the dismissal of the complaint here. *See* 216 F.3d at 314-15 (A-27a-31a). In contrast, based upon its holding that the PSLRA does require that a plaintiff plead all facts supporting her belief — as the plain language of the statute demands — the Ninth Circuit affirmed the dismissal of the *Silicon Graphics* complaint, *see* 183 F.3d at 991, in part for its failure to "mention . . . the sources of [the plaintiff's] information." *Id.* at 985.

In sum, the decision of the Second Circuit as to the meaning of "all facts" in § 78u-4(b)(1) creates a square and irreconcilable conflict with the very language of the statute itself, with Congress's intent in enacting it, with this Court's well-established rules of statutory interpretation and with the decision of the only other court of appeals to interpret this language. For these reasons, the decision of the Second Circuit should be reviewed and reversed.

III.

PROPER AND UNIFORM INTERPRETATION OF THE PSLRA'S PLEADING STANDARDS IS AN ISSUE OF VITAL IMPORTANCE TO THE EFFICIENT OPERATION AND INTEGRITY OF THE FEDERAL COURTS

Congress passed the PSLRA to eliminate what it found to be abuse of the federal securities laws by private litigants, conduct that was fueled by the inconsistent pleading standards imposed by the courts of appeals, some of which permitted only the barest of allegations to sustain a complaint alleging fraud. *See* Conference Report at 41, *reprinted in* 1995 U.S.C.C.A.N. at 740. Since the PSLRA's enactment, the prevalence of securities class actions in the federal courts has only increased, and the circuit courts' interpretation of the PSLRA's pleading standards has only created a new conflict among the courts. Not only does this frustrate Congress's intent in enacting the statute, but it also permits complaints that would be dismissed in those circuits interpreting the PSLRA as elevating the pre-existing Rule 9(b) standard to survive in those circuits that have interpreted the PSLRA to be more lenient, a result that can only encourage forum shopping among plaintiffs.

There can be no real doubt that securities fraud class actions are of significant, and growing, importance to the federal courts. The volume of securities class actions filed in the federal courts is substantial, and has been increasing since the passage of the PSLRA. From 1991 through 1995, an average of 177 issuers of securities were named as defendants in securities class actions annually. *See* Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year's Experience, in Securities Litigation 1997,* at 955, 965-66 (PLI Corp. L. & Practice Course Handbook Series No. B-1015, 1997). From 1996 to 1999 —

after the PSLRA became effective — this number grew to an average of 189 issuers per year. *See* Stanford Securities Class Action Clearinghouse, *Federal Litigation Box Score*, 22 Dec. 1995 to 14 September 2000 (visited September 15 2000) <http:*//securities.stanford.edu*>.

The ratio of securities class actions to the total number of class actions pending in the federal courts has also been on the rise since the PSLRA became effective. In 1999, securities class actions comprised 37 percent of pending class actions and 33 percent of class actions commenced in the federal courts. *See* Mecham (1999), *supra*, at 389-96; *see also* Mecham (1998), *supra*, at 398-404 (in 1998, 29 percent of pending class actions and 31 percent of class actions filed in federal court were securities class actions). In contrast, in 1997, securities class action lawsuits made up only 21 percent of total pending class actions and 18 percent of class actions commenced in the federal district courts. *See* Mecham (1997), *supra*, at 383-88. How these lawsuits are adjudicated — consistently or inconsistently, following a heightened pleading standard or a diminished one — may be expected to contribute to the efficiencies (or lack thereof) of our judicial system. *See* Joseph A. Grundfest, *et al.*, *Securities Class Action Litigation in Q1 1998: A Report to NASDAQ from the Stanford Law School Securities Class Action Clearinghouse, in Securities Litigation 1998*, at 69, 71-72 (PLI Corp. L. & Practice Handbook Series No. B-1070, 1998) (discussing rising volume of securities fraud class actions in federal courts and noting inconsistency in interpretation and application of the PSLRA's pleading standards by the courts).

Litigation of securities class actions demands a disproportionate share of the time and resources available to the federal judiciary. A recent study conducted for the Federal Judicial Center has determined that the median time from

filing to disposition of securities class actions exceeds the median time from filing to disposition of all other civil actions (excluding prisoner actions) by more than 15 months. Thomas E. Willging, *et al.*, *Empirical Study of Class Actions in Four Federal District Courts* 117 (1996). Class actions require the expenditure of more judicial time than any other type of civil cases in the federal courts, with the sole exception of habeas corpus proceedings in death penalty cases. *Id.* at 22. Further, securities class actions command substantially more judicial time than any other type of class action. *Id.* at 23.

In light of their manifest impact on the federal courts, it is vital that securities class actions be litigated uniformly throughout the nation. As discussed above, perhaps Congress's strongest motivation in passing the PSLRA was to eradicate the disharmony among the circuit courts in their interpretations of the requirements of Rule 9(b) as applied to securities class actions. If the conflicting interpretations of the PSLRA are not resolved by this Court on certiorari review, the predictable result will be that the ever increasing volume of securities class actions will be concentrated in those circuits construing the statute in the most lenient manner, as plaintiffs seize upon the opportunity to file their cases in the jurisdictions perceived to be most amenable to them. This practice of searching for the most hospitable forum is one that Congress has found to exist to a significant degree, and one that Congress has clearly manifested a resolve to eradicate.

Thus, alarmed by the use by plaintiffs of securities class actions based on state law to frustrate the objectives of the PSLRA, Congress passed the Securities Litigation Uniform Standards Act of 1998 (the "Uniform Standards Act"), which provides, in pertinent part, that no class action alleging violations of any state statutory or common law

analogous to Section 10(b) of the Securities Exchange Act of 1934 may be maintained in any state or federal court. 15 U.S.C. § 78bb(f)(1). Congress enacted the Uniform Standards Act to stem the flow of post-PSLRA securities class actions from the federal courts, where the procedural protections of the PSLRA (including its heightened pleading standard) prevailed, to state courts, where no such protections were available. Congress's action was based on its finding that "since passage of the [PSLRA], plaintiffs' lawyers have sought to circumvent the [PSLRA's] provisions by exploiting differences between Federal and State laws by filing frivolous and speculative lawsuits in State court, where essentially none of the procedural or substantive protections against abusive suits are available." H.R. Conf. Rep. No. 105-803, at 14-15 (1998).

Their recourse to state courts, and the more lenient pleading standards in effect there, having been cut off by Congress, plaintiffs will now naturally gravitate to the federal courts applying the most relaxed interpretation of the PSLRA — again frustrating Congress's objective in enacting that statute — unless and until this Court resolves the differing interpretations of the PSLRA by the circuit courts, thus ensuring uniform application of its pleading standards, as Congress intended, and removing any incentive for securities class action plaintiffs to engage in forum shopping.

CONCLUSION

For the foregoing reasons, the Court should grant a writ of certiorari to review the decision of the Second Circuit Court of Appeals vacating the District Court's dismissal of respondents' amended complaint.

Respectfully submitted,

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APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DATED AND DECIDED JUNE 21, 2000

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

August Term 1999

(Argued September 15, 1999 Decided JUN 21 2000)

Docket No. 98-9641

CAROL NOVAK, ROBERT NIEMAN, JOSEPH DESENA, on behalf of themselves and all others similarly situated,

Plaintiffs-Appellants,

– v. –

SALLY FRAME KASAKS, PAUL E. FRANCIS, JOSEPH R. GROMEK, ANNTAYLOR STORES CORPORATION and ANNTAYLOR, INC.,

Defendants-Appellees,

MERRILL LYNCH & COMPANY, MERRILL LYNCH, PIERCE, FENNER & SMITH INC., MERRILL LYNCH CAPITAL PARTNERS, INC., ML IBK POSITIONS, INC., MERCHANT BANKING L.P. NO. III, KECALP, INC., GERALD S. ARMSTRONG, JAMES J. BURKE, JR.,

Defendants.

Appendix A

Before: WALKER, LEVAL, and POOLER, *Circuit Judges*.

Appeal from the judgment of the United States District Court for the Southern District of New York (Allen G. Schwartz, *District Judge*), granting motion by defendants-appellees to dismiss the complaint.

Vacated and remanded.

* * *

JOHN M. WALKER, Jr., *Circuit Judge*:

In 1996, plaintiffs-appellants filed this securities fraud class action, alleging violations of sections 10(b) and 20(a) of the Securities Exchange Act ("the 1934 Act") and Rule 10b-5 promulgated thereunder. In two opinions issued in 1998, the district court dismissed both the original complaint and the plaintiffs' amended complaint pursuant to Fed. R. Civ. P. 12(b)(6) and 15 U.S.C. § 78u-4(b)(3)(A) for failure to plead with sufficient particularity facts supporting a strong inference that the defendants had acted fraudulently. *See Novak v. Kasaks*, 997 F. Supp. 425 (S.D.N.Y. 1998) ("*Novak I*") (dismissing original complaint); *Novak v. Kasaks*, 26 F. Supp. 2d 658 (S.D.N.Y. 1998) ("*Novak II*") (dismissing amended complaint). On appeal, the appellants contend that the district judge erred in granting the defendants' motions to dismiss.

In light of Second Circuit precedent and the provisions of the Private Securities Litigation Reform Act ("PSLRA"), we hold that the district court erred in: (1) concluding that

the plaintiffs had failed to plead sufficient facts to support a strong inference of fraudulent intent; and (2) imposing an exceedingly onerous burden on the plaintiffs with respect to their obligation to plead facts with particularity. We see no persuasive alternative grounds for upholding the district court's dismissal of the complaint. Accordingly, we vacate the judgment of the district court and remand for further proceedings consistent with these determinations. In addition, we instruct the district court to allow the plaintiffs to replead to the extent they wish to do so in light of this opinion.

BACKGROUND

On April 25, 1996, plaintiffs Carol Novak and Robert Nieman brought this action on behalf of all purchasers of the common stock of the AnnTaylor Stores Corporation between February 3, 1994, and May 4, 1995 (the "Class Period"). In their complaint, the plaintiffs named two groups of defendants: (1) *the AnnTaylor defendants*, both the corporation itself — which, through its wholly-owned subsidiary, defendant AnnTaylor, Inc., is a specialty retailer of women's clothing, shoes, and accessories — and several officers at the highest level of management; and (2) *the Merrill Lynch defendants*, a group of entities and individuals that collectively held a dominant share of AnnTaylor stock and sold a significant fraction of their holdings during the Class Period.

The complaint — in both its original and amended forms — essentially alleges that, during the Class Period, the defendants made, or controlled others who made, materially

false and misleading statements and omissions concerning the financial performance of AnnTaylor ("the Company"), primarily by failing properly to account for millions of dollars of inventory. According to the plaintiffs, the defendants knowingly and intentionally issued financial statements that overstated AnnTaylor's financial condition by accounting for inventory that they knew to be obsolete and nearly worthless at inflated values and by deliberately failing to adhere to the Company's publicly stated markdown policy. The following facts are taken largely from the plaintiffs' complaint.

The plaintiffs' specific allegations focus on AnnTaylor's so-called "Box and Hold" practice, whereby a substantial and growing quantity of out-of-date inventory was stored in several warehouses during the Class Period without being marked down. Internal Company documents ("Weekly Reports") — distributed at regular Monday morning merchandise meetings in which the AnnTaylor defendants participated — distinguished between regular inventory and "Box and Hold" inventory. According to the complaint, these reports demonstrated that: (1) much of the "Box and Hold" inventory was several years old and thus unlikely to be sold at full price, if at all; and (2) the levels of such inventory grew significantly during the Class Period, from about 10% to about 34% of total inventory. However, AnnTaylor's public financial statements did not distinguish between types of inventory, nor did AnnTaylor write off any of the "Box and Hold" inventory during the Class Period, allegedly in violation of Generally Accepted Accounting Principles ("GAAP") that required markdowns under these circumstances. Instead, the defendants made or caused to be

made a series of positive statements to the public about the status of AnnTaylor's inventories, describing them at various points during the Class Period as "under control," "in good shape," and at "reasonable" or "expected" levels; stating that "no major or unusual markdowns were anticipated"; and attributing rising levels of inventory to growth, expansion, and planned future sales.

The plaintiffs contend that this course of conduct amounts to securities fraud. Had AnnTaylor taken appropriate write-downs, they argue, the Company's earnings would have been substantially lower than reported. Thus, the AnnTaylor defendants' alleged deception painted too rosy a picture of the Company's current performance and future prospects and kept the company's stock price at an artificially high level during the Class Period. According to the amended complaint, during this time,

> many AnnTaylor executives demanded that [the individual AnnTaylor] defendants . . . end the Box & Hold practice as it made no business sense and was growing out of control. Defendants' response . . . was that AnnTaylor could not "afford" to eliminate or write-down the Box & Hold inventory because doing so would "kill" the Company's reported financial results and/or profit margins and damage the Company on "Wall Street."

Ultimately, the defendants were forced to publicly acknowledge serious inventory problems — i.e., that inventories were too high and liquidation would result in

much lower fiscal 1995 earnings than expected — at which point AnnTaylor stock prices fell precipitously, to the plaintiffs' detriment.

On July 1, 1996, in response to these allegations, the defendants moved to dismiss the action, and on August 16, 1996, the district judge granted a motion by the defendants to stay all discovery pending a ruling on the motions to dismiss pursuant to 15 U.S.C. § 78u-4(b)(3)(B).

On March 10, 1998, the district court issued an opinion and order granting the defendants' motions to dismiss the complaint. *See Novak I*, 997 F. Supp. at 426. The court concluded that "the fatal defect in the complaint lies in its allegations of scienter." *Id.* at 430. Specifically, the plaintiffs had "fail[ed] to plead facts giving rise to a strong inference of fraudulent intent" in that they did not "allege with sufficient specificity that . . . defendants . . . were aware that much of their inventory was worthless or seriously overvalued, or were reckless as to whether that was the case." *Id.* at 430-31. According to the district court, in order to meet the pleading requirement, the plaintiffs needed to identify the confidential sources of their information, *see id.* at 431-32, include written documentation of the "Box and Hold" practice in their complaint, *see id.* at 432, and allege facts showing that the Merrill Lynch defendants actually knew about "Box and Hold," *see id.* at 434.

On April 9, 1998, the plaintiffs filed an amended complaint. The defendants thereafter served motions to dismiss. On November 9, 1998, the district court dismissed the plaintiffs' amended complaint with prejudice. *See Novak II*, 26 F. Supp.

2d at 660. In the district court's view, the amended complaint failed to remedy the defects of the original one, including lack of particularity in pleading, unnamed sources, and lack of specific evidence of the Merrill Lynch defendants' knowledge of the "Box and Hold" practice. *See id.* at 660-62. In addition, the district court found "that it would be futile to permit further amendment" of the complaint and thus dismissed it with prejudice. *Id.* at 663. This appeal followed.

The plaintiffs subsequently reached a settlement with the Merrill Lynch defendants and withdrew the appeal as against them. Accordingly, our discussion pertains solely to the claims against the AnnTaylor defendants. In particular, we do not reach the question of control-person liability under § 20(a) of the 1934 Act, since this claim pertains primarily to the Merrill Lynch defendants. We are not concerned with § 20(a) liability as to the AnnTaylor defendants because they are also alleged to be primary violators under the 1934 Act, who may be held directly liable under § 10(b).

DISCUSSION

We review *de novo* a district court's order dismissing a complaint on the pleadings and accept as true all facts alleged in the complaint. *See Stevelman v. Alias Research Inc.*, 174 F.3d 79, 83 (2d Cir. 1999) (citing *Chill v. General Elec. Co.*, 101 F.3d 263, 267 (2d Cir. 1996)). In this case, we are called upon to decide principally whether the district court, in assessing the sufficiency of the pleadings, applied appropriate standards in light of our precedents and the provisions of the PSLRA and whether it erred in concluding that the plaintiffs had failed to state a claim. We must also

decide whether, even if the district court erred, there are alternative grounds for affirming the dismissal of the plaintiffs' § 10(b) claims.

I. *Sufficiency of the Pleadings*

The landscape of securities fraud litigation has been transformed in recent years by the passage of the PSLRA. This case requires us to determine the impact of two provisions in this legislation on the pleading standard for scienter and the required degree of particularity in pleading in this circuit.

A. The PSLRA and Anti-Fraud Provisions in Federal Securities Laws

Section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, prohibit fraudulent activities in connection with securities transactions. Section 10(b) makes it unlawful

> [t]o use or employ, in connection with the purchase or sale of any security . . . , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b). Rule 10b-5 specifies the following actions among the types of behavior proscribed by the statute:

> To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . .

17 C.F.R. § 240.10b-5.

In order to state a claim under these provisions, a complaint must allege that the defendants acted with scienter. *See, e.g., Chill*, 101 F.3d at 266. This scienter requirement for a private action under Rule 10b-5 has been firmly established for at least a generation. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (holding that no "private cause of action for damages will lie under § 10(b) and Rule 10b-5 in the absence of any allegation of 'scienter' — intent to deceive, manipulate, or defraud"); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1301 (2d Cir. 1973) (in banc) ("Other cases in this circuit clearly indicate that 'facts amounting to *scienter*, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud' are essential to the imposition of liability.") (quoting *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442, 445 (2d Cir. 1971)). This case pertains not to the scienter requirement itself, but rather to the pleading requirement for scienter in the securities fraud context. Prior to the passage of the PSLRA, we had decided that, in order to state a claim for securities fraud, plaintiffs had to allege facts giving rise to "a strong inference of fraudulent intent." *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 52 (2d Cir. 1995).

In addition to pleading scienter, it is well-established that a securities fraud complaint must also plead certain facts with particularity in order to state a claim. Fed. R. Civ. P. 9(b) requires that, whenever a complaint contains allegations of fraud, "the circumstances constituting fraud . . . shall be stated with particularity." *See also Chill*, 101 F.3d at 267 (noting that "the actual fraudulent statements or conduct and the fraud alleged must be stated with particularity") (internal citations omitted). "[A] complaint making such allegations must '(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent.' " *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994) (quoting *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1175 (2d Cir. 1993)).

In 1995, Congress amended the 1934 Act through passage of the PSLRA. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified at 15 U.S.C. §§ 77k, 77l, 77z-1, 77z-2, 78a, 78j-1, 78t, 78u, 78u-4, 78u-5). Legislators were apparently motivated in large part by a perceived need to deter strike suits wherein opportunistic private plaintiffs file securities fraud claims of dubious merit in order to exact large settlement recoveries. *See* H.R. Conf. Rep. No. 104-369, at 31 (1995) (noting "significant evidence of abuse in private securities lawsuits," including "the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer," and "the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle"), *reprinted in* 1995 U.S.C.C.A.N. 730, 730.

In order "to curtail the filing of meritless lawsuits," the PSLRA imposed stringent procedural requirements on plaintiffs pursuing private securities fraud actions. *See id.* at 41. This case concerns two of these provisions in particular. First, the statute requires that,

> [i]n any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, *state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.*

15 U.S.C. § 78u-4(b)(2) (emphasis added) [hereinafter "paragraph (b)(2)"]. Second, the statute requires that,

> [i]n any private action arising under this chapter in which the plaintiff alleges that the defendant —
>
> (A) made an untrue statement of a material fact; or
>
> (B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading;
>
> the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, *if an*

> *allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.*

15 U.S.C. § 78u-4(b)(1) (emphasis added) [hereinafter "paragraph (b)(1)"]. In addition, § 21D(b)(3)(A) of the PSLRA requires courts to dismiss complaints that fail to meet the pleading requirements of paragraphs (b)(1) and (b)(2). *See* 15 U.S.C. § 78u-4(b)(3)(A). We must determine the impact of these new requirements in order to decide whether the plaintiffs in this case have pleaded sufficient facts with enough particularity to state a claim under the 1934 Act.

B. The Pleading Standard for Scienter

1. The Second Circuit's Pre-PSLRA Pleading Standard

We can easily summarize the pleading standard for scienter that prevailed in this circuit prior to the PSLRA:

> [P]laintiffs must allege facts that give rise to a strong inference of fraudulent intent. "The requisite 'strong inference' of fraud may be established either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness."

Acito, 47 F.3d at 52 (quoting *Shields*, 25 F.3d at 1128) (internal citations omitted). However, this statement of the

standard conceals the complexity and uncertainty that often surround its application. This difficulty in application stems, at least in part, from the "inevitable tension" between the interests in deterring securities fraud and deterring strike suits. *See In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 263 (2d Cir. 1993). As a result, different courts applying the pleading standard to differing factual circumstances may reach seemingly disparate results. *See id.* at 264. Nevertheless, we discern some basic patterns in our case law under § 10(b) and Rule 10b-5 that help to provide substance to the general language of the standard itself.

We described the type of motive and opportunity required to plead scienter under our pre-reform standard as follows:

> Motive would entail concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged. Opportunity would entail the means and likely prospect of achieving concrete benefits by the means alleged.

Shields, 25 F.3d at 1130. Plaintiffs could not proceed based on motives possessed by virtually all corporate insiders, including: (1) the desire to maintain a high corporate credit rating, *see San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos., Inc.*, 75 F.3d 801, 814 (2d Cir. 1996), or otherwise sustain "the appearance of corporate profitability, or of the success of an investment," *Chill*, 101 F.3d at 268; and (2) the desire to maintain a high stock price in order to increase executive compensation, *see Acito*, 47 F.3d at 54, or prolong the benefits of holding

corporate office, *see Shields*, 25 F.3d at 1130. Rather, plaintiffs had to allege that defendants benefitted in some concrete and personal way from the purported fraud. This requirement was generally met when corporate insiders were alleged to have misrepresented to the public material facts about the corporation's performance or prospects in order to keep the stock price artificially high while they sold their own shares at a profit. *See, e.g.*, *Stevelman*, 174 F.3d at 85; *Goldman v. Belden*, 754 F.2d 1059, 1070 (2d Cir. 1985). Accordingly, in the ordinary case, adequate motive arose from the desire to profit from extensive insider sales.

Plaintiffs could also meet the pre-PSLRA pleading standard by alleging facts that constituted strong circumstantial evidence of conscious misbehavior or recklessness on the part of defendants. Intentional misconduct is easily identified since it encompasses deliberate illegal behavior, such as securities trading by insiders privy to undisclosed and material information, *see Simon DeBartolo Group, L.P. v. Richard E. Jacobs Group, Inc.*, 186 F.3d 157, 168-69 (2d Cir. 1999), or knowing sale of a company's stock at an unwarranted discount, *see Schoenbaum v. Firstbrook*, 405 F.2d 215, 219 (2d Cir. 1968) (in banc).

Recklessness is harder to identify with such precision and consistency. In 1978, when we first held that recklessness suffices to plead scienter under § 10(b) and Rule 10b-5, we defined reckless conduct as:

> at the least, conduct which is "highly unreasonable" and which represents "an extreme departure from

> the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it."

Rolf v. Blyth, Eastman Dillon & Co., Inc., 570 F.2d 38, 47 (2d Cir. 1978) (quoting *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977)) (ellipsis in original). Similarly, we later noted that " '[a]n egregious refusal to see the obvious, or to investigate the doubtful, may in some cases give rise to an inference of . . . recklessness.' " *Chill*, 101 F.3d at 269 (quoting *Goldman v. McMahan, Brafman, Morgan & Co.*, 706 F. Supp. 256, 259 (S.D.N.Y. 1989)) (ellipsis in original).

However, these general standards offer little insight into precisely what actions and behaviors constitute recklessness sufficient for § 10(b) liability. It is the actual facts of our securities fraud cases that provide the most concrete guidance as to the types of allegations required to meet the pre-PSLRA pleading standard in this circuit.

According to these cases, securities fraud claims typically have sufficed to state a claim based on recklessness when they have specifically alleged defendants' knowledge of facts or access to information contradicting their public statements. Under such circumstances, defendants knew or, more importantly, should have known that they were misrepresenting material facts related to the corporation. Thus, for example, the pleading standard was met where the plaintiffs alleged that the defendants made or authorized statements that sales to China would be "an important new

source of revenue" when they knew or should have known that Chinese import restrictions in place at the time would severely limit such sales. *See Cosmas v. Hassett*, 886 F.2d 8, 12 (2d Cir. 1989). Similarly, the pleading standard was met where the plaintiffs alleged that the defendants released to the investing public several highly positive predictions about the marketing prospects of a computer system to record hotel guests' long-distance telephone calls when they knew or should have known several facts about the system and its consumers that revealed "grave uncertainties and problems concerning future sales of" the system. *Goldman*, 754 F.2d at 1063, 1070.

Under certain circumstances, we have found allegations of recklessness to be sufficient where plaintiffs alleged facts demonstrating that defendants failed to review or check information that they had a duty to monitor, or ignored obvious signs of fraud. Thus, the pleading standard was met where the plaintiff alleged that the defendant, his broker, consistently reassured the plaintiff that the investment advisor responsible for the plaintiff's portfolio "knew what he was doing" but never actually investigated the advisor's decisions to determine "whether there was a basis for the [defendant's] assertions." *Rolf*, 570 F.2d at 47-48. Similarly, the pleading standard was met where the defendant allegedly included false statements in SEC filings despite "the obviously evasive and suspicious statements made to him" by the corporate officials upon whom he was relying for this information and despite outside counsel's recommendation that these statements not be included. *SEC v. McNulty*, 137 F.3d 732, 741 (2d Cir. 1998).

At the same time, however, we have identified several important limitations on the scope of liability for securities fraud based on reckless conduct. First, we have refused to allow plaintiffs to proceed with allegations of "fraud by hindsight." *See Stevelman*, 174 F.3d at 85. Corporate officials need not be clairvoyant; they are only responsible for revealing those material facts reasonably available to them. *See Denny v. Barber*, 576 F.2d 465, 470 (2d Cir. 1978). Thus, allegations that defendants should have anticipated future events and made certain disclosures earlier than they actually did do not suffice to make out a claim of securities fraud. *See Acito*, 47 F.3d at 53.

Second, as long as the public statements are consistent with reasonably available data, corporate officials need not present an overly gloomy or cautious picture of current performance and future prospects. *See Stevelman*, 174 F.3d at 85; *Shields*, 25 F.3d at 1129-30. Where plaintiffs contend defendants had access to contrary facts, they must specifically identify the reports or statements containing this information. *See San Leandro*, 75 F.3d at 812 ("Plaintiffs' unsupported general claim of the existence of confidential company sales reports that revealed the larger decline in sales is insufficient to survive a motion to dismiss.").

Third, there are limits to the scope of liability for failure adequately to monitor the allegedly fraudulent behavior of others. Thus, the failure of a non-fiduciary accounting firm to identify problems with the defendant-company's internal controls and accounting practices does not constitute reckless conduct sufficient for § 10(b) liability. *See Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111, 120 (2d Cir. 1982). Similarly,

the failure of a parent company to interpret extraordinarily positive performance by its subsidiary — specifically, the "unprecedented and dramatically increasing profitability" of a particular form of trading — as a sign of problems and thus to investigate further does not amount to recklessness under the securities laws. *See Chill*, 101 F.3d at 269-70.

Finally, allegations of GAAP violations or accounting irregularities, standing alone, are insufficient to state a securities fraud claim. *See Stevelman*, 174 F.3d at 84; *Chill*, 101 F.3d at 270. Only where such allegations are coupled with evidence of "corresponding fraudulent intent," *Chill*, 101 F.3d at 270, might they be sufficient.

We now examine to what extent these lessons from our prior case law have survived the recent reform of the securities laws.

2. Implications of the PSLRA for the Pleading Standard for Scienter in this Circuit

Courts have disagreed on the proper interpretation of the new pleading requirement imposed by paragraph (b)(2) in light of the text of the PSLRA and its legislative history. They have generally come to one of two conclusions:

> (1) The statute effectively adopts the Second Circuit's pleading standard for scienter wholesale, and thus plaintiffs may continue to state a claim by pleading either motive and opportunity or strong circumstantial evidence of recklessness or conscious misbehavior. *See In re Advanta Corp.*

Sec. Litig., 180 F.3d 525 (3d Cir. 1999); *Press v. Chemical Invest. Servs. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999) (dicta); *Rubinstein v. Skyteller, Inc.*, 48 F. Supp. 2d 315, 320 (S.D.N.Y. 1999) (following *Press*).

(2) The statute strengthens the Second Circuit's standard by rejecting the simple pleading of motive and opportunity. *See Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1283 (11th Cir. 1999); *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 979 (9th Cir. 1999); *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 550-51 (6th Cir. 1999); *Novak I*, 997 F. Supp. at 430; *In re Glenayre Tech., Inc. Sec. Litig.*, 982 F. Supp. 294, 298 (S.D.N.Y. 1997); *In re Baesa Sec. Litig.*, 969 F. Supp. 238, 241-42 (S.D.N.Y. 1997).

Our own review of the text and legislative history leads us to a middle ground. We conclude that the PSLRA effectively raised the nationwide pleading standard to that previously existing in this circuit and no higher (with the exception of the "with particularity" requirement). At the same time, however, we believe that Congress's failure to include language about motive and opportunity suggests that we need not be wedded to these concepts in articulating the prevailing standard. We are led to these conclusions by the considerations that follow.

In order to gauge the implications of paragraph (b)(2), we apply familiar canons of statutory construction. We look first to the text of the statute. If that language is plain and its

meaning sufficiently clear, we need look no further. *See Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 254 (1992). Only if the text of the statute is not unambiguous do we turn for guidance to legislative history and the purposes of the statute. *See Dowling v. United States*, 473 U.S. 207, 218 (1985). Applying these principles, we conclude that the enactment of paragraph (b)(2) did not change the basic pleading standard for scienter in this circuit.

In this case, our interpretive task begins and ends with the text of the statute. In drafting paragraph (b)(2), Congress specifically incorporated this circuit's "strong inference" language to define the pleading standard for securities fraud cases. *Compare* 15 U.S.C. § 78u-4(b)(2) (requiring plaintiffs to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind"), *with Acito*, 47 F.3d at 52 ("[P]laintiffs must allege facts that give rise to a strong inference of fraudulent intent."). We agree with the Third Circuit that this "use of the Second Circuit's language compels the conclusion that the Reform Act establishes a pleading standard approximately equal in stringency to that of the Second Circuit." *In re Advanta Corp.*, 180 F.3d at 534. *Cf. United States v. Johnson*, 14 F.3d 766, 770 (2d Cir. 1994) (finding that Congress's use of "substantially identical language" to that of an earlier statute "bespeaks an intention to import" judicial interpretations of that language into the new statute).

Given the absence of ambiguity in the statutory text, no resort to legislative history or the purposes of the PSLRA is required. In any event, there is nothing in these sources that would alter our conclusion. As far as the general purposes

of the PSLRA are concerned, Congress plainly sought to impose a stricter nationwide pleading standard and did so. But this purpose does not require raising the standard above that of this circuit, particularly in light of the explicit Congressional recognition that our pre-PSLRA standard was the most stringent in the nation. *See* H.R. Conf. Rep. No. 104-369, at 41. "In many jurisdictions, adoption of a 'strong inference' standard will substantially heighten the barriers to pleading scienter, a result Congress expressly intended. Moreover, even in jurisdictions already employing the Second Circuit standard, the additional requirement that plaintiffs state facts 'with particularity' represents a heightening of the standard." *In re Advanta Corp.*, 180 F.3d at 534.

Meanwhile, in our view, as is so often the case with legislative history generally, the legislative history of the PSLRA contains "conflicting expressions of legislative intent" with respect to the pleading requirement. *Id.* at 533. For example, while the Conference Committee rejected language from the Senate bill that would have adopted the Second Circuit rule wholesale, including language about motive and opportunity and recklessness, *see* H.R. Conf. Rep. No. 104-369, at 41 & 48 n.23, the Senate Committee reporting the bill stated that it was proposing not "a new and untested pleading standard that would generate additional litigation," but rather "a uniform standard modeled upon the pleading standard of the Second Circuit." S. Rep. No. 104-98, at 15 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 694 (noting that courts interpreting the proposed "strong inference" pleading standard might find Second Circuit case law "instructive").

When all is said and done, we believe that the enactment of paragraph (b)(2) did not change the basic pleading standard for scienter in this circuit (except by the addition of the words "with particularity"). Accordingly, we hold that the PSLRA adopted our "strong inference" standard: In order to plead scienter, plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind," as required by the language of the Act itself. Although litigants and lower courts need and should not employ or rely on magic words such as "motive and opportunity," we believe that our prior case law may be helpful in providing guidance as to how the "strong inference" standard may be met. Therefore, in applying this standard, district courts should look to the cases and factors discussed in Section I.B.1 above to determine whether plaintiffs have pleaded facts giving rise to the requisite "strong inference." These cases suggest, in brief, that the inference may arise where the complaint sufficiently alleges that the defendants: (1) benefitted in a concrete and personal way from the purported fraud, *see supra* at **[page 14-15]**; (2) engaged in deliberately illegal behavior, *see supra* at **[page 15]**; (3) knew facts or had access to information suggesting that their public statements were not accurate, *see supra* at **[page 16-17]**; or (4) failed to check information they had a duty to monitor, *see supra* at **[pages 17-18]**. We now turn to the complaint in this case to determine whether the plaintiffs have met their burden to plead scienter.

3. Strong Inference of Fraudulent Intent on the Part of the AnnTaylor Defendants

The district court concluded that the plaintiffs had failed to plead facts giving rise to a strong inference of the defendants' fraudulent intent, as required to state a claim under § 10(b). We disagree.

According to the complaint, the AnnTaylor defendants knew at all relevant times that the Company had serious inventory problems that they sought to disguise by adopting the "Box and Hold" scheme. By refusing to mark down inventory they knew to be "worthless," "obsolete," and "unsalable," the defendants acted "intentionally and deliberately" to artificially inflate AnnTaylor's reported financial results. They discussed the need to mark down inventory but refused to do so because that would damage the Company's financial prospects. Further, in approving the inventory management practices of "Box and Hold," the defendants knowingly sanctioned procedures that violated the Company's own markdown policy, as stated in the Company's public filings. In doing so, they caused those filings to be materially misleading in that the disclosed policy no longer reflected actual practice. Lastly, despite knowledge of the true reasons for rising inventory levels, the defendants made repeated statements to the investment community either offering false reassurances that inventory was under control or giving false explanations for its growth. In short, the Complaint alleges that the defendants engaged in conscious misstatements with the intent to deceive. There is no doubt that this pleading satisfies the standard for scienter under *Hochfelder*, and the requirement of the PSLRA that plaintiffs

state facts with particularity that give rise to a strong inference of the required state of mind.

In the end, we believe that the district court applied the correct standard but erroneously found that this standard was not met on these pleadings. According to the district court, the scienter requirement can be satisfied by pleading either "conscious recklessness" — i.e., a state of mind "approximating actual intent, and not merely a heightened form of negligence" — or "actual intent." *Novak I*, 997 F. Supp. at 430. This was an accurate statement of the law. However, the district court believed that the facts pleaded by the plaintiffs supported nothing more than an inference that the managers of AnnTaylor disagreed over matters of business judgment, such as the valuation of inventory and the timing of markdowns. *See Novak II*, 26 F. Supp. 2d at 660. This was incorrect as a matter of law. When managers deliberately make materially false statements concerning inventory with the intent to deceive the investment community, they have engaged in conduct actionable under the securities laws.

C. Particularity of the Facts Pleaded

The district court also found the facts pleaded by the plaintiffs insufficiently particularized, in large part because they did not reveal the identity of the personal sources of their critical factual allegations. We disagree with the district court's reasoning and accordingly vacate and remand for further proceedings consistent with the discussion that follows.

As discussed above, Rule 9(b) has long required plaintiffs in securities fraud cases to state "the circumstances constituting fraud . . . with particularity." The PSLRA imposed an additional requirement: whenever plaintiffs allege, on information and belief, that defendants made material misstatements or omissions, the complaint must "state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). This requirement plainly applies in this case. In numerous places in their complaint, the plaintiffs allege, based on information and belief, that the AnnTaylor defendants made materially misleading statements or omissions. Most importantly, they allege that the defendants made false statements concerning the value of inventory because "Box and Hold" merchandise was "unsalable," "obsolete," and "nearly worthless," and its "actual value was nearly zero." In order to survive at this stage, the complaint must state with particularity sufficient facts to support the belief that the "Box and Hold" inventory was of limited value, and accordingly that the defendants' positive public statements concerning inventory growth were false and misleading.

The district court concluded that the plaintiffs had failed to meet these particularity requirements, in substantial part because they failed to reveal their confidential sources for some of the facts on which their belief in the essential worthlessness of the "Box and Hold" inventory was based. *See Novak I*, 997 F. Supp. at 431-32; *Novak II*, 26 F. Supp. 2d at 660-61. The lower court found the plaintiffs' allegations in this respect at worst "conclusory, unsupported and inflammatory," and at best "based upon reports by . . . anonymous 'former employees' " who should have been

identified by name. *Novak II*, 26 F. Supp. 2d at 661. The district court's reasoning and conclusions were flawed in several respects.

For one thing, the complaint provides specific facts concerning the Company's significant write-off of inventory directly following the Class Period, which tends to support the plaintiffs' contention that inventory was seriously overvalued at the time the purportedly misleading statements were made. Specifically, the plaintiffs allege that: (1) in AnnTaylor's May 1995 reporting of its first quarter fiscal 1995 results, the Company "admitted to analysts that its inventories were too high" and that "inventory liquidation" would follow; (2) in AnnTaylor's July 29, 1995 10-Q filed with the SEC, it "admitted that the decrease in the Company's gross profit percentage was attributable to 'increased cost of goods sold as a percentage of net sales, *primarily resulting from markdowns*' "; and (3) a January 22, 1996 Weekly Report showed that even six months after the Class Period, substantial amounts of "Box and Hold" inventory still dated from 1993 and 1994, which supports the inference that inventory during the Class Period was similarly dated. Thus, the complaint identifies with particularity several documentary sources that support the plaintiffs' belief that serious inventory problems existed during the Class Period itself.

We recognize that the complaint does not state with particularity every fact upon which this belief was based, since it is apparent that there were also personal sources who were not specifically identified. However, plaintiffs who rely on confidential sources are not always required to name those

sources, even when they make allegations on information and belief concerning false or misleading statements, as here.

First, there is nothing in the caselaw of this circuit that requires plaintiffs to reveal confidential sources at the pleading stage. The defendants rely heavily on *Segan v. Dreyfus Corp.*, 513 F.2d 695 (2d Cir. 1975), in which we held that a plaintiff's complaint was insufficiently specific and rejected the argument that further disclosure would, among other things, identify a confidential informant. *See id.* at 696. But in *Dreyfus*, we held only that the plaintiff had to plead additional facts, not that the plaintiff was required to reveal the name of the informant. *See id.* ("A suit charging fraud may not be based on *facts* so secret that the defendants cannot be told what they are.") (emphasis added). Some district courts in this circuit have on occasion stated that Rule 9(b) requires plaintiffs in securities fraud cases to allege the "sources that support the alleged specific facts," *e.g.*, *Blanchard v. Katz*, 705 F. Supp. 1011, 1012 (S.D.N.Y. 1989); *Crystal v. Foy*, 562 F. Supp. 422, 425 (S.D.N.Y. 1983), but in no case have they dismissed a complaint for failure to identify confidential sources.

Second, while paragraph (b)(1) may compel revelation of confidential sources under certain circumstances, such circumstances are not necessarily present in this case. The defendants point to district court decisions outside this circuit that hold or imply that the PSLRA generally requires plaintiffs to include the names of their confidential sources. *See In re Silicon Graphics Inc. Sec. Litig.*, 970 F. Supp. 746, 763 (N.D. Cal. 1997); *In re Aetna Inc. Sec. Litig.*, No. CIV. A. MDL 1219, 1999 WL 354527, at *4 (E.D. Pa. May 26,

1999). However, this rule is based on a misreading of the legislative history of the PSLRA. Specifically, the court in *Silicon Graphics* relied primarily on the hyperbolic statements of legislators attempting (unsuccessfully) to amend the proposed Act to lighten plaintiffs' pleading burden. *See Silicon Graphics*, 970 F. Supp. at 763-64. In fact, the applicable provision of the law as ultimately enacted requires plaintiffs to plead only facts and makes no mention of the sources of these facts. *See* 15 U.S.C. § 78u-4(b)(1).

More fundamentally, our reading of the PSLRA rejects any notion that confidential sources must be named as a general matter. In our view, notwithstanding the use of the word "all," paragraph (b)(1) does not require that plaintiffs plead with particularity every single fact upon which their beliefs concerning false or misleading statements are based. Rather, plaintiffs need only plead with particularity *sufficient* facts to support those beliefs.[1] Accordingly, where plaintiffs rely on confidential personal sources but also on other facts, they need not name their sources as long as the latter facts provide an adequate basis for believing that the defendants' statements were false. Moreover, even if personal sources

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1. Paragraph (b)(1) is strangely drafted. Reading "all" literally would produce illogical results that Congress cannot have intended. Contrary to the clearly expressed purpose of the PSLRA, it would allow complaints to survive dismissal where "all" the facts supporting the plaintiff's information and belief were pled, but those facts were patently insufficient to support that belief. Equally peculiarly, it would require dismissal where the complaint pled facts fully sufficient to support a convincing inference if any known facts were omitted. Our reading of the provision focuses on whether the facts alleged are sufficient to support a reasonable belief as to the misleading nature of the statement or omission.

must be identified, there is no requirement that they be named, provided they are described in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged. In both of these situations, the plaintiffs will have pleaded enough facts to support their belief, even though some arguably relevant facts have been left out. Accordingly, a complaint can meet the new pleading requirement imposed by paragraph (b)(1) by providing documentary evidence and/or a sufficient general description of the personal sources of the plaintiffs' beliefs.

Thus, we find no requirement in existing law that, in the ordinary course, complaints in securities fraud cases must name confidential sources, and we see no reason to impose such a requirement under the circumstances of this case. "The primary purpose of Rule 9(b) is to afford defendant fair notice of the plaintiff's claim and the factual ground upon which it is based." *Ross v. Bolton*, 904 F.2d 819, 823 (2d Cir. 1990). This purpose, which also underlies paragraph (b)(1), can be served without requiring plaintiffs to name their confidential sources as long as they supply sufficient specific facts to support their allegations. Imposing a general requirement of disclosure of confidential sources serves no legitimate pleading purpose while it could deter informants from providing critical information to investigators in meritorious cases or invite retaliation against them.

We express no view as to whether the plaintiffs' allegations in this case were sufficiently particularized. Instead, we remand to the district court with instructions to: (1) allow the plaintiffs to replead in light of our discussion

above; and (2) reconsider the particularity of the plaintiffs' pleadings in light of the proper standards.

II. *Alternative Grounds for Dismissal* –

The appellees argue that we still may affirm the district court's dismissal because: (1) the appellants have not adequately alleged that statements made by securities analysts can be attributed to the AnnTaylor defendants; and (2) the alleged false and misleading statements made during the Class Period are not actionable in any event. We reject both arguments.

Under the law of this circuit, plaintiffs may state a claim against corporate officials for false and misleading information disseminated through analysts' reports by alleging that the officials either: (1) "intentionally foster[ed] a mistaken belief concerning a material fact" that was incorporated into reports; or (2) adopted or placed their "imprimatur" on the reports. *See Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 163-64 (2d Cir. 1980). This was plainly the case here. The plaintiffs alleged that the AnnTaylor defendants both made misstatements that were later incorporated into analysts' reports *and* subsequently (at least implicitly) adopted the contents of those reports. These allegations were sufficiently detailed to meet the pleading threshold because generally the circumstances of the statements — including dates and participants — were particularized. *See Acito*, 47 F.3d at 51.

Moreover, the types of statements the defendants are alleged to have made or adopted are actionable. While

statements containing simple economic projections, expressions of optimism, and other puffery are insufficient, *see, e.g.*, *Friedman v. Mohasco Corp.*, 929 F.2d 77, 79 (2d Cir. 1991), defendants may be liable for misrepresentations of existing facts, *see In re Prudential Sec. Inc. Ltd. Partnerships Litig.*, 930 F. Supp. 68, 74-75 (S.D.N.Y. 1996). Here, the complaint alleges that the defendants did more than just offer rosy predictions; the defendants stated that the inventory situation was "in good shape" or "under control" while they allegedly knew that the contrary was true. Assuming, as we must at this stage, the accuracy of the plaintiffs' allegations about AnnTaylor's "Box and Hold" practices, these statements were plainly false and misleading.

CONCLUSION

For the foregoing reasons, we hold, first, that: (a) in order to plead scienter in securities fraud cases, plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind"; and (b) the plaintiffs here pleaded sufficient facts to establish a strong inference of fraudulent intent on the part of the AnnTaylor defendants. Second, we hold that the district court erred, under the circumstances of this case, by requiring the plaintiffs to reveal the names of their confidential sources in order to meet the particularity requirements of the PSLRA. On remand, we instruct the district court to: (a) permit the plaintiffs to replead; and (b) evaluate their pleadings anew in light of our interpretation of these requirements. Finally, we see no alternative grounds for affirming the district court's dismissal of the plaintiffs' complaint. Accordingly, the judgment of the district court is vacated and the case remanded for further proceedings consistent with these rulings.

APPENDIX B — AMENDED OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK DATED NOVEMBER 12, 1998

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

96 Civ. 3073 (AGS)

CAROL NOVAK and ROBERT NIEMAN, on behalf of themselves and all others similarly situated,

Plaintiffs,

– against –

SALLY FRAME KASAKS, PAUL E. FRANCIS, JOSEPH R. GROMEK, GERALD S. ARMSTRONG, JAMES J. BURKE, JR., MERRILL LYNCH & CO., MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, MERRILL LYNCH CAPITAL PARTNERS, INC., ML IBK POSITIONS, INC., MERCHANT BANKING L.P. NO. III, KECALP, INC., ANNTAYLOR STORES CORPORATION and ANNTAYLOR, INC.,

Defendants.

AMENDED OPINION AND ORDER

ALLEN G. SCHWARTZ, DISTRICT JUDGE:

By Opinion and Order dated March 10, 1998, the Court dismissed the complaint in this action pursuant to

Appendix B

Rule 12(b)(6) of the Federal Rules of Civil Procedure (failure to state a claim) and Section 21D(b)(3) of the Securities Exchange Act of 1934 (failure to plead fraud with particularity and an inability to do so). *Novak v. Kasaks*, 997 F. Supp. 425 (S.D.N.Y. 1998). Now before the Court are an amended complaint and a new set of motions to dismiss. For the reasons set forth below, defendants' motions to dismiss are granted.

Familiarity with the Court's earlier Order is assumed. Briefly, plaintiffs had alleged that defendants artificially inflated the price of AnnTaylor stock by hiding excess inventory and failing to take write-downs at the proper times. The Court found that plaintiffs had failed to plead facts giving rise to a strong inference of defendants' fraudulent intent, and therefore had not satisfied the scienter pleading requirements of the Private Securities Litigation Reform Act of 1995 ("PSLRA"). *Novak*, 997 F. Supp. at 430-31. More specifically, we found that

> the complaint fails to allege with sufficient specificity that at the time the AnnTaylor defendants made favorable statements to securities analysts, they were aware that much of their inventory was worthless or seriously overvalued, or were reckless as to whether that was the case.

Id. at 431.

The Court also found that plaintiffs had failed properly to allege that the AnnTaylor defendants' actions were

wrongful, rather than simply a matter of business judgment; had failed to specify the individuals from whom they had gleaned information included in the complaint; had failed properly to allege that the Merrill Lynch defendants were aware of any scheme to hide inventory; and had failed to plead a claim for control person or control group liability. *Id.* at 431-35. The Court now finds that the amended complaint fails to correct these deficiencies, or even to address them in any meaningful way.

We turn first to the basis for the amended complaint. In our earlier Opinion, we found that the complaint was "woefully devoid" of particularity in stating the basis for plaintiffs' allegations. Plaintiffs had stated only that they relied upon "investigation of their counsel, which included a review of AnnTaylor's SEC filings, securities analysts reports and advisories about the Company, press releases issued by the Company, media reports about the Company and discussions with consultants." *Novak*, 997 F. Supp. at 431.

The amended complaint states:

> Plaintiffs' investigation has included, among other things, a review of: (i) the public filings of AnnTaylor Stores Corporation with the Securities and Exchange Commission (the "SEC"); (ii) press releases and other public statements issued by defendants; (iii) published reports and news articles regarding the Company; (iv) internal AnnTaylor documents obtained through plaintiffs' investigation; and (v) documents produced by

> various non-parties in this litigation, as well as confidential communications with certain former AnnTaylor employees and independent consultants.

(Am. Compl. at 1.)

Items (i), (ii), and (iii) reiterate sources of information referenced in the original complaint. Item (iv) appears to refer to weekly reports used at AnnTaylor management meetings. We discuss these more fully below. Item (v) refers to other documents; the Court, however is unable to ascertain from the body of the amended complaint what these documents might be, what information they might contain, or who provided them to plaintiffs. This lack of particularity in pleading is exactly what led the Court to dismiss the original complaint.

Item (v) also refers to communications with anonymous employees and consultants. In our earlier opinion, we stated that if "unnamed consultants provided information forming the basis for these allegations, then the consultants should have been named in the complaint." *Novak*, 997 F. Supp. at 431. Plaintiffs have chosen to ignore this clear mandate. As we discuss in more detail below, the Court therefore rejects as improperly pleaded allegations based upon reports from these anonymous sources.

Turning next to the content of the amended complaint, the Court finds that it contains few allegations not included in the original complaint. What new allegations there are appear to be directed at demonstrating that the AnnTaylor defendants knew that the box-and-hold inventory "was nearly

worthless and could not and would not be sold at its stated value." (Am. Compl. ¶ 35.) The allegations involve documents allegedly available to the AnnTaylor defendants and conversations which allegedly took place at management meetings.

Plaintiffs allege, and the Court accepts for purposes of this motion, that at a meeting held each Monday, the AnnTaylor defendants received a weekly report detailing inventory levels. (Am. Compl. ¶ 34.) The total amount of inventory was reported, and was then broken down into the amount at AnnTaylor Stores, at AnnTaylor Lofts, and in "Box and Hold." The box and hold number was further subdivided into seasonal lines (e.g., "Fall 92"). The Court finds that these documents, if they exist, do nothing more than confirm a fact already acknowledged by AnnTaylor — that AnnTaylor held merchandise in warehouses and ultimately marked down this merchandise. *Novak*, 997 F. Supp. at 432.

In addition, the amended complaint alleges that

> numerous internal discussions occurred between defendants Kasaks, Francis and Gromek and other senior AnnTaylor executives at these regular merchandise "recap" meetings and throughout the Class Period regarding the Box & Hold inventories, during which many AnnTaylor executives demanded that defendants Kasaks, Francis and Gromek end the Box & Hold practice as it made no business sense and was growing out of control. Defendants' response to all of these demands was that AnnTaylor could not "afford"

> to eliminate or write-down the Box & Hold inventory because doing so would "kill" the Company's reported financial results and/or profit margins and damage the Company on "Wall Street. . . . Defendants Kasaks, Francis and Gromek each knew, at all relevant times, that this inventory due to its age and condition was nearly worthless and could not and would not be sold at its stated value."

(Am. Compl. ¶ 35.)

Paragraph 35 provides an excellent example of the improper pleading which leads the Court once again to dismiss the complaint. First, we can only assume that it is based upon reports by the anonymous "former employees" discussed *supra*. Plaintiffs' failure to identify these individuals ignores the clear mandate of the Court in our earlier opinion, and is contrary to the particularity requirements of the PSLRA. 15 U.S.C. § 78u-4(b)(1).

Second, even if these allegations were properly pled, they represent nothing more than disagreement by certain AnnTaylor executives with business decisions made by the AnnTaylor defendants. The paragraph alleges only that certain executives disagreed with aspects of the box and hold practice, and that the AnnTaylor defendants exercised business judgment in deciding when to take markdowns. We rejected this approach in our earlier opinion:

> The implication is that inventory was placed in containers and stored for some period of time or

> held for sale in later seasons. That action, even if it were a fact, is one essentially of business judgment. If there is more than business judgment involved, i.e., something wrongful, then plaintiffs were required under Rule 9(b) to set forth, in detail, the particulars of that wrongfulness."

Novak, 997 F. Supp. at 431.

Third, plaintiffs offer absolutely no support for the conclusory, unsupported and inflammatory allegation that the AnnTaylor defendants knew the box and hold inventory to be "nearly worthless." We criticized this pleading technique, too, in our earlier opinion: "Plaintiffs have . . . relied virtually exclusively on conclusory language (e.g., 'inventories had *exploded to dangerously bloated levels*') and hot words (e.g., 'plunged into a liquidity crisis'). *Id.*

The amended complaint also alleges that:

> A January 22, 1996 Weekly Report . . . demonstrates that as of January 22, 1996, *over six months after the end of the Class Period*, 384,674 out of a total . . . 2.99 million apparel units (or 13% of total apparel units) and 75,556 out of a total . . . 371,967 shoe units (or 20% of total shoe units) remained inside of "Box & Hold" as of that date, consisting of merchandise going as far back as the *Spring of 1993*! The reported value of this inventory, which consists primarily of 1993 and 1994 Class Period merchandise was in excess of $14 million as of January 22, 1996,

> or 14% of AnnTaylor's total publicly-reported inventory at the end of fiscal 1995. Yet, its actual value was nearly zero.

(Am. Compl. ¶ 37.)

This paragraph, too, suffers from numerous pleading defects. First, the Court finds no relevance in a document describing the situation which existed, as plaintiffs emphatically put it, *over six months after the end of the Class Period*. Second, the Court is unable to ascertain the meaning of the "primarily." Third, and perhaps most importantly, plaintiffs offer no support for the allegation that the value of the box and hold inventory was "nearly zero," nor do they attempt to demonstrate why $14 million was not a proper value to assign to the inventory. By plaintiffs' own count, there were 460,230 units of warehoused inventory. Dividing this number into $14 million results in an average value of $30 per unit. Plaintiffs offer no explanation as to why that number is an excessive average valuation for upscale clothing and shoes.

In sum, the Court finds that plaintiffs have once again failed properly to plead scienter on the part of the AnnTaylor defendants. We turn next to the amended complaint's scienter allegations in regard to the Merrill Lynch defendants. In our earlier opinion, we dismissed the claims as to defendants Burke and Armstrong because there was no allegation that they had access to information not available to the AnnTaylor defendants (who we had already found lacked scienter), and because plaintiffs were unable or unwilling to provide details as to Armstrong's and Burke's actual knowledge at any given

point in time, and as to whether Armstrong and Burke had communicated this knowledge to the other Merrill Lynch defendants. *Novak*, 997 F. Supp. at 433-35.

Although this discussion consumed two full pages of a nine-page decision, plaintiffs respond to the Court's concerns in only a single paragraph of the amended complaint:

> Given the nature and size of this fraudulent [box and hold] scheme, it is inconceivable that defendants Kasaks, Gromek and Francis did not share this data with Merrill Lynch and, specifically, defendants Armstrong and Burke, who were defendant Francis's former business partners, oversaw Merrill Lynch's controlling investment in AnnTaylor, and sat on the Compensation Committee of AnnTaylor's Board of Directors and decided, among other things, the compensation packages of defendants Kasaks, Francis and Gromek.

(Am. Compl. ¶ 42.)

It is not acceptable to the Court that plaintiffs would base an allegation on nothing more than the concept that it is inconceivable that something did not happen, especially in light of our earlier opinion, in which we repeatedly emphasized the PSLRA's requirement of pleading with particularity. We need only adopt a statement we made in dismissing the previous complaint: "The complaint's allegations as to scienter on the part of any of the Merrill Lynch defendants, including Armstrong and Burke, are thus

not pled with the particularity required by the PSLRA, nor supported by an adequate factual background." *Novak*, 997 F. Supp. at 434-35.

Turning to control person or control group liability, we again need only adopt the views expressed in our earlier opinion, as plaintiffs have chosen to include no new allegations in the amended complaint:

> In order to establish a claim for control person liability under Section 20, plaintiffs must establish (1) a primary violation of the 1934 Act, (2) control of the primary violator by the defendant, and (3) the defendant's culpability in the fraud perpetrated by the controlled person. *See Securities & Exchange Com'n v. First Jersey Securities, Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996). First, as the Court has found, plaintiffs have failed properly to plead a violation of the 1934 Act. Second, as we also have noted, plaintiffs have failed properly to allege scienter and/or culpability on the part of "Merrill Lynch." Even had we found a properly pled violation of the 1934 Act, we would not automatically impute this violation to "Merrill Lynch" as a controlling entity. *See Baesa*, 969 F. Supp. at 242 ("[T]he law in this circuit is clear that a subsidiary's fraud cannot be automatically imputed to its corporate parent."). *See also Chill v. General Elec. Co.*, 101 F.3d 263, 270 (2d Cir. 1996) (holding that a parent company would, at the very least, have to have been deliberately blind

to its subsidiary's fraud in order to have the requisite scienter).

Novak, 997 F. Supp. at 435.

Finally the Court notes that the amended complaint expands plaintiffs' allegations as to defendants' violation of Generally Accepted Accounting Principles ("GAAP"). Plaintiffs, however, offer no support for their contention that "[a]llegations that defendants violated specific Generally Accepted Accounting Principles ("GAAP") state a claim for securities fraud based on improper accounting practices." (Pl. Mem. at 18.) The cases cited by plaintiffs clearly state that violations of GAAP may give rise to an inference of fraudulent intent only when coupled with other specific and properly pled allegations of fraud.[1] As plaintiffs have failed to plead fraud with particularity, the GAAP allegations are insufficient to state a claim under the PSLRA.

In sum, as we did with the original complaint, the Court finds that the absence of adequate allegations of scienter in

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1. *Bell v. Fore Sys., Inc.*, No. 97-civ-1265, 1998 WL 535573, at *3-*4 (W.D. Pa. June 29, 1998) (GAAP allegations coupled with detailed description of alleged fraudulent transactions sufficient); *Gross v. Medaphis Corp.*, 977 F. Supp. 1463, 1466, 1472 (N.D. Ga. 1997) (GAAP allegations coupled with allegation that defendants provided customers with secret side letters relieving them of their obligations sufficient); *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1313 (C.D. Cal. 1996) (GAAP violations must be "combined with other circumstances suggesting fraudulent intent"); *In re Digi Int'l, Inc. Sec. Litig.*, 6 F. Supp. 2d 1089, 1098 (same); *Cherednichenko v. Quarterback Corp.*, [Current Tr. Binder], Fed. Sec. L. Rep. (CCH) ¶ 90,108 (C.D. Cal. Nov. 26 1997) (same).

the amended complaint is fatal to plaintiffs' claims under Section 10(b) of the 1934 Act and Rule 10b-5, and that plaintiffs have failed to meet the minimal requirements to plead control person liability. The complaint will be dismissed.

Although leave to file an amended complaint is to be generously granted, *see*, e.g., *Luce v. Edelstein*, 802 F.2d 49, 56 (2d Cir. 1986), such a grant is not appropriate where it would be futile to permit amendment, *see San Leandro Emergency Med. Group v. Philip Morris Cos.*, 75 F.3d 801, 815 (2d Cir. 1996). In the instant matter, plaintiffs were given leave to amend the original complaint at the time we dismissed it. In doing so, plaintiffs ignored every mandate and suggestion given by the Court, and submitted an amended complaint substantially identical to the original complaint. We now find that it would be futile to permit further amendment.

As this decision represents a final adjudication of this action, the PSLRA requires that the Court determine whether the parties and their attorneys have complied with Fed. R. Civ. P. 11(b). 15 U.S.C. § 78u-4(c)(1). The Court finds that they have so complied.

CONCLUSION

For the reasons set forth above, defendants' motions to dismiss the amended complaint under Fed. R. Civ. P. 12(b)(6) and Section 21D(b)(3) of the 1934 Act are granted. The amended complaint is dismissed with prejudice. The Clerk of the Court is directed to close the file in this action.

Appendix B

SO ORDERED.

Dated: New York, New York
November 12, 1998

s/ Allen G. Schwartz
ALLEN G. SCHWARTZ, U.S.D.J.

APPENDIX C — OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK DATED MARCH 10, 1998

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

96 Civ. 3073 (AGS)

CAROL NOVAK and ROBERT NIEMAN, on behalf of themselves and all others similarly situated,

Plaintiffs,

– against –

SALLY FRAME KASAKS, PAUL E. FRANCIS, JOSEPH R. GROMEK, GERALD S. ARMSTRONG, JAMES J. BURKE, JR., MERRILL LYNCH & CO., MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, MERRILL LYNCH CAPITAL PARTNERS, INC., ML IBK POSITIONS, INC., MERCHANT BANKING L.P. NO. III, KECALP, INC., ANNTAYLOR STORES CORPORATION and ANNTAYLOR, INC.,

Defendants.

OPINION AND ORDER

ALLEN G. SCHWARTZ, DISTRICT JUDGE:

In this action, based upon alleged securities fraud, defendants move to dismiss the complaint pursuant to

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Rule 12(b)(6) of the Federal Rules of Civil Procedure (failure to state a claim) and Section 21D(b)(3) of the Securities Exchange Act of 1934 (failure to plead fraud with particularity and an inability to do so). For the reasons set forth below, defendants' motions to dismiss are granted.

BACKGROUND[1]

1. *The Parties*

Plaintiff Carol Novak purchased twenty-five shares of AnnTaylor stock on November 30, 1994, and plaintiff Robert Nieman purchased three hundred shares of AnnTaylor stock on April 16, 1995. (Compl. ¶ 31.) The named plaintiffs purport to represent a class of persons who bought AnnTaylor stock during the asserted class period of February 3, 1994 through May 4, 1995 (the "Class Period"). (Compl. ¶ 1.)

Defendant AnnTaylor Stores Corporation, through its wholly-owned subsidiary AnnTaylor, Inc. (collectively, "AnnTaylor"), is a specialty retailer of women's apparel, shoes, and accessories. (Compl. ¶ 32(a).) Defendant Sally Frame Kasaks is the Chief Executive Officer and Chairman of the Board of AnnTaylor. (Compl. ¶ 33(a).) Defendant Paul E. Francis is Executive Vice President for Finance and Administration, Chief Financial Officer, and a director of AnnTaylor. (Compl. ¶ 33(b).) Defendant Joseph R. Gromek was a Senior Vice President and General Merchandise

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1. The relevant undisputed facts discussed herein are drawn from the allegations of the complaint or otherwise reflected in the record, including the affidavits and exhibits submitted by the parties.

Manager of AnnTaylor from April 1993 through April 1995.[2] (Compl. ¶ 33(c).) We shall refer to these defendants collectively as the "AnnTaylor defendants."

Defendant Merrill Lynch & Co. is a holding company which operates, in part, through its subsidiaries defendant Merrill Lynch, Pierce, Fenner & Smith Incorporated and defendant Merrill Lynch Capital Partners, Inc. (Compl. ¶ 34(a).) The latter entity, in turn, is the general partner in three limited partnerships (not defendants in this action) which sold 3.8 million shares during the Class Period. (Compl. ¶ 34(c).) "Merrill Lynch"[3] controls and held AnnTaylor stock through defendants ML IBK Positions, Inc., Merchant Banking L.P. No. III, and KECALP, Inc. (Compl. ¶ 34(b).) Defendants Gerald S. Armstrong and James J. Burke, Jr. are directors of AnnTaylor, partners in Merrill Lynch Capital Partners, and former managing directors of

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2. The Court notes that the complaint is particularly deficient in specific allegations of culpable behavior on the part of defendant Gromek, stating nothing more than that Gromek was one of three people who gave "key information" to a certain securities analyst (Compl. ¶ 92), and that he was one of numerous presenters at an annual AnnTaylor investor conference (Compl. ¶ 95).

3. In paragraph 34(d) of the Complaint, plaintiffs state that "[u]nless the context requires otherwise, "Merrill Lynch" means all . . . Merrill Lynch entities." This lack of specificity in pleading not only renders this recitation of the facts less informative than it might otherwise have been, but also violates the rule that "[w]here multiple defendants are asked to respond to allegations of fraud, the complaint should inform each defendant of the nature of his alleged participation in the fraud." *DiVittorio v. Equidyne Extractive Indus., Inc.*, 822 F.2d 1242, 1247 (2d Cir. 1987).

the Investment Banking Division of Merrill Lynch & Co. (Compl. ¶¶ 33(d)(i) and 33(e)(i).) We shall refer to the parties enumerated in this paragraph collectively as the "Merrill Lynch defendants."[4]

2. *The Allegations*

Simply put, plaintiffs allege that the AnnTaylor defendants artificially inflated the price of AnnTaylor stock by hiding excess inventory and failing to take write-downs at the proper times. Plaintiffs maintain that all defendants had actual or constructive knowledge that the company had serious inventory problems which were inconsistent with optimistic representations contained in public statements issued on AnnTaylor's behalf during the Class Period. Plaintiffs further contend that defendants refrained from disclosing this adverse information to the public until May 1995, and that these misrepresentations and omissions render defendants liable for securities fraud.

More specifically, plaintiffs make the following allegations:

- On February 3, February 14, and February 28, 1994, defendants Kasaks and Francis told securities analysts that inventories were in good shape and under control. (Compl. ¶¶ 47-49.)

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4. We denominate the defendants in this manner for the sake of semantic coherence. This in no way implies that global references in the complaint to "Merrill Lynch" are sufficiently detailed so as to withstand a motion to dismiss.

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- In early 1994, "Merrill Lynch and AnnTaylor" did a national "roadshow" during which "AnnTaylor executives" said that inventories were under control and within expected levels. (Compl. ¶ 56.)

- On June 1, 1994, defendants Kasaks and Francis told securities analysts that inventories were at very reasonable levels. (Compl. ¶ 62.)

- On June 13, 1994, AnnTaylor filed its Form 10-Q for the quarter ending April 30, 1994, signed by defendant Francis, with the Securities and Exchange Commission ("SEC"). This form attributed higher inventory levels to expansion. (Compl. ¶ 63.)

- On July 7, 1994, "AnnTaylor insiders" told securities analysts that inventory levels were in good shape. (Compl. ¶ 64.)

- On August 4, 1994, defendants Kasaks and Francis told securities analysts that inventories were in great shape. (Compl. ¶ 65.)

- On September 1, 1994, defendants Kasaks and Francis told securities analysts that inventories were light. (Compl. ¶ 68.)

- On September 12, 1994, AnnTaylor filed its Form 10-Q for the quarter ending July 30, 1994, signed by defendant Francis, with the SEC. This form attributed higher inventory levels to expansion. (Compl. ¶ 71.)

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- In mid-September 1994, defendants Kasaks and Francis told securities analysts that inventories were under control. (Compl. ¶ 74.)

- On November 8, 1994, defendants Kasaks and Francis told securities analysts that inventories were up 64%, but that this was due to accelerating growth. (Compl. ¶ 81.)

- On December 9, 1994, AnnTaylor filed its Form 10-Q for the quarter ending October 29, 1994, signed by defendant Francis, with the SEC. This form attributed higher inventory levels to expansion. (Compl. ¶ 87.)

- On January 3, 1995, defendants Kasaks and Francis told securities analysts that no major or unusual markdowns were anticipated. (Compl. ¶ 91.)

- On February 21, 1995, defendants Kasaks and Francis told securities analysts that inventories were up 22%, but that this was in line with planned sales. (Compl. ¶ 94.)

- On April 19, 1995, "AnnTaylor" told securities analysts that inventories would be in good shape at the end of April. (Compl.¶ 103.)

- In early May 1995, AnnTaylor announced that same store sales were down, that new stores were performing well below expectations, that its inventories were too high, and that inventory liquidation would result in fiscal 1995 earnings much lower than previously forecast. (Compl. ¶ 107.)

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Plaintiffs allege that this series of unwaveringly favorable statements followed by an unexpected announcement of financial difficulties caused the price of AnnTaylor stock to rise to an artificially high level and then plummet. Specifically, the stock climbed from $20-1/2 per share in January 1994 to a high of $44-7/8 in November 1994. (Compl. ¶ 1.) Shares traded in the $37 range until April 1995, but had lost 50% of their value by early May, dropping to $18-3/8. This included a one-day plunge of 25% on May 3-4, coinciding with one of the negative announcements. (Compl. ¶ 107.) By October 1995, the share price had declined to $15, and thereafter fell to a low of $9. (Compl. ¶ 18.)

Plaintiffs further allege that throughout the Class Period, the AnnTaylor defendants were participating in a "box-and-hold" scheme in which excess inventory was hidden in warehouses and not written down according to Generally Accepted Accounting Principles ("GAAP"). (Comp. ¶ 117-118.) Had AnnTaylor timely taken these write-downs, plaintiffs contend, the company would have shown a net loss for the fiscal year ending January 29, 1994 (rather than the $3.2 million net income reported), and net income of approximately $10 million less than the $31.7 million reported for the year ending January 28, 1995. (Compl. ¶¶ 119, 123.) By hiding inventory and delaying in taking write-downs, the AnnTaylor defendants presumably first caused stock prices to rise to inflated levels by misleading the public as to the company's financial health, and then caused prices to plummet by revealing the true state of affairs.

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Plaintiffs allege that among the factors motivating the AnnTaylor defendants to forestall disclosure of the company's true inventory situation was a desire to inflate the share price in advance of a May 1994 secondary stock offering. (Compl. ¶ 6.) In this offering, "Merrill Lynch" sold off 4 million shares of AnnTaylor stock which it had been holding since the initial public offering in May 1991. (Compl. ¶¶ 2, 6.) The secondary offering also permitted AnnTaylor to sell one million new shares, allowing it to reduce its debt levels. (Compl. ¶ 6.) Plaintiffs further allege that AnnTaylor was motivated to keep the share price high after the offering so that Merrill Lynch could unload even more shares, which it did during late November and early December 1994, selling 781,000 additional shares. (Compl. ¶¶ 9, 13.)

As we have noted, plaintiffs purchased shares of AnnTaylor common stock in the period between February 3, 1994 and May 4, 1995, during which time the AnnTaylor defendants allegedly hid the fact that unsalable inventory was accumulating and that earnings were therefore overstated. Plaintiffs advance a "fraud on the market" theory of reliance and causation, alleging that they purchased AnnTaylor stock at artificially inflated prices and suffered damage as a result of the AnnTaylor defendants' material misrepresentations and omissions. Plaintiffs assert claims for relief against all defendants under Section 10(b) of the Securities Exchange Act of 1934 ("the 1934 Act"), 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. 240.10b-5, and against defendants Kasaks, Burke, Armstrong, AnnTaylor and "Merrill Lynch" under Section 20 of the 1934 Act, 15 U.S.C. § 78t.

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DISCUSSION

It is by now well recognized that securities class actions such as this one present an "inevitable tension between two powerful interests." *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 263 (2d Cir. 1993). On the one hand, there is the interest in deterring fraud in the securities market and remedying it when it occurs. As Chief Judge Newman noted in *Time Warner*:

> That interest [in deterring fraud] is served by recognizing that the victims of fraud often are unable to detail their allegations until they have some opportunity to conduct discovery of those reasonably suspected of having perpetrated a fraud. Consistent with that interest, modern pleading rules usually permit a complaint to survive dismissal unless . . . "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *See Conley v. Gibson*, 355 U.S. 41, 45-46, 78 S. Ct. 99, 101-102, 2 LED.2d 80 (1957).

Id. On the other hand, there is society's interest in "deterring the use of the litigation process as a device for extracting undeserved settlements as the price of avoiding the extensive discovery costs that frequently ensue once a complaint survives dismissal, even though no recovery would occur if the suit were litigated to completion." *Id.* As Chief Judge Newman noted, the resolution of these two competing interests is often difficult in the absence of a more refined

statutory standard than the vague contours of Section 10(b) or a more detailed attempt at rulemaking than Rule 10b-5.

This case presents a textbook example of the tension between these two competing interests. After much deliberation, and in light of recent guidance from Congress in the Private Securities Litigation Reform Act of 1995 ("PSLRA"), the Court has concluded that the complaint must be dismissed because it fails to allege facts giving rise to a strong inference of fraudulent intent.

A. *Sufficiency of Scienter Allegations*

To state a cause of action for securities fraud under Section 10(b) of the 1934 Act and Rule 10b-5, a plaintiff must plead that the defendant made a false statement or omitted a material fact, with scienter, and that plaintiff's reliance on defendant's action caused plaintiff injury. *San Leandro Emergency Med. Group v. Philip Morris Cos.*, 75 F.3d 801, 808 (2d Cir. 1996) (citations omitted).

Rule 9(b) of the Federal Rules of Civil Procedure provides that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge and other condition of mind of a person may be averred generally." An essential purpose of Rule 9(b) is to prevent plaintiffs from using "conclusory generalizations . . . to set off on a long and expensive discovery process in the hope of uncovering some sort of wrongdoing or of obtaining a substantial settlement." *Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111, 116 (2d Cir. 1982); *see also DiVittorio v. Equidyne Extractive Indus., Inc.*, 822 F.2d 1242, 1247

(2d Cir. 1987) ("Rule 9(b) is designed to further three goals: (1) providing a defendant fair notice of plaintiff's claim, to enable preparation of defense; (2) protecting a defendant from harm to his reputation or goodwill; and (3) reducing the number of strike suits."). However, Rule 9(b) does not abrogate the general rule that "pleadings are to be construed in a light most favorable to the pleader and accepted as true [and should not be dismissed] unless it appears that plaintiff can prove no set of facts that would entitle him to relief." *Ross v. Bolton*, 904 F.2d 819, 823 (2d Cir. 1990).

San Leandro is representative of cases in this Circuit in which courts have carefully scrutinized securities fraud complaints with regard to the sufficiency of allegations of scienter. Courts in this Circuit have not been hesitant to dismiss securities fraud complaints on findings of insufficient allegations of fraudulent intent. *See San Leandro*, 75 F.3d at 812-814; *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 53-54 (2d Cir. 1995); *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1127-28 (2d Cir. 1994); *Connecticut Nat'l Bank v. Fluor Corp.*, 808 F.2d 957, 962 (2d Cir. 1987).

Furthermore, under the PSLRA, a complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). Prior to the enactment of the PSLRA, the rule in regard to scienter in this circuit was that a "strong inference" might be established by showing either motive and opportunity to commit fraud or circumstantial evidence of either reckless or conscious behavior. *See, e.g., Time Warner*, 9 F.3d at 269. There has been much debate in the federal courts as to whether the PSLRA adopted or strengthened this Second Circuit standard.

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The growing trend in the courts, and particularly in this district, is to find that Congress intended to strengthen the Second Circuit standard. The two leading Southern District cases, *Norwood Venture Corp. v. Converse, Inc.*, 959 F. Supp. 205 (S.D.N.Y. 1997) and *In re Baesa Securities Litigation*, 969 F. Supp. 238 (S.D.N.Y. 1997), both held that the pleading of motive and opportunity no longer suffices to raise a strong inference of scienter. *See Baesa*, 969 F. Supp. at 242; *Norwood*, 959 F. Supp. at 208.

In reaching this conclusion, Judge Rakoff relied upon what he considered to be the "clear language" of the PSLRA. In the court's view, had Congress wished to adopt the "motive and opportunity" prong of the Second Circuit standard, it would have said so. *Baesa*, 969 F. Supp. at 242. Judge Baer, on the other hand, based his decision on the legislative history of the PSLRA. He relied particularly upon statements in a House Conference Report that Congress intended to "strengthen existing requirements" and did not "intend to codify the Second Circuit's case law," and upon the President's veto message (a veto which Congress overrode) stating that it was "crystal clear" that Congress intended the PSLRA to go beyond the Second Circuit standard. *Norwood*, 959 F. Supp. at 208. Without expressing a view as to the superiority of either rationale, the Court adopts the view that evidence of motive and opportunity no longer suffices to plead scienter.[5]

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5. Although not necessary to our decision, we note that plaintiffs have not satisfied even the motive and opportunity prong. Plaintiffs attribute three motives to the AnnTaylor defendants for making allegedly fraudulent favorable statements about the

(Cont'd)

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The courts have also been divided as to whether recklessness is a sufficient state of mind under the PSLRA, as it was in virtually every circuit prior to the enactment of the law, or if conscious intent to defraud is now required. Judge Rakoff, in *Baesa*, found that Congress expressed no clear intention in the PSLRA to eliminate the recklessness prong of the scienter requirement. *See Baesa*, 969 F. Supp. at 241. Judge Baer, on the other hand, again relying on the legislative history of the PSLRA, implied in *Norwood* that Congress intended to eliminate recklessness along with the

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(Cont'd)
company: to conceal their mismanagement and to enhance their compensation and prestige (Compl. ¶ 39), to enhance the value of their holdings and options (*id.*), and to raise capital (Compl. ¶ 5). These allegations of motive are insufficient as a matter of law. *See Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1130 (2d Cir. 1994) (motive must be more than an aim to prolong the benefits of one's executive position or to continue employment); *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995) ("[T]he existence, without more, of executive compensation dependent upon stock value does not give rise to a strong inference of scienter."); *Shields*, 25 F.3d at 1131 (stock ownership alone is not enough; shares must be sold at an inflated price); *Glickman v. Alexander & Alexander Servs., Inc.*, No. 93-Civ-7594, 1996 WL 88570, at *7 (S.D.N.Y. Feb. 29, 1996) (vague allegations of motive like "raising desperately needed capital" are too generalized to satisfy the scienter requirement). Plaintiffs' allegation as to the motive of the Merrill Lynch defendants, i.e., to sell off the shares which they were holding (Compl. ¶ 6), is equally unavailing. To constitute motive, stock sales must be "unusual." *See Acito*, 47 F.3d at 54. In the instant case, the Merrill Lynch defendants held their stock for approximately five years, and then sold off less than one-half their holdings. (Compl. ¶¶ 2, 6, 1(a).) Plaintiffs make no allegation as to why this sort of activity by entities engaged in the investment banking industry is "unusual."

motive and opportunity prong. *See Norwood*, 959 F. Supp. at 208. However, in *In re Glenayre Technologies, Inc. Securities Litigation*, 982 F. Supp. 294, 298 (S.D.N.Y. 1997), Judge Baer clarified that conscious recklessness — approximating actual intent, and not merely a heightened form of negligence — would suffice. We join the emerging consensus in this district that either conscious recklessness or actual intent satisfy the PSLRA's scienter requirement.

In the Court's view, the fatal defect in the complaint lies in its allegations of scienter. Specifically, the Court finds that the complaint must be dismissed because it fails to plead facts giving rise to a strong inference of fraudulent intent, i.e., that defendants' conduct was conscious or reckless. Put in the simplest terms, the complaint fails to allege with sufficient specificity that at the time the AnnTaylor defendants made favorable statements to securities analysts, they were aware that much of their inventory was worthless or seriously overvalued, or were reckless as to whether that was the case.

This deficiency is particularly striking where the target of the allegations is conceded to be "a specialty retailer of women's apparel, shoes, and accessories;" a company engaged in a business that is affected by considerations of fashion and taste. In effect, AnnTaylor was necessarily involved in the generation of inventory based upon predictions as to product that was expected to sell at a particular time or season. Investors acquiring shares in such an entity knew or had reason to know that depending upon fashion or marketing considerations, there would necessarily be inventory fluctuations. The term "box-and-hold" is

nowhere defined in the complaint; nor is any information provided as to the source or origin of such a term. The implication is that inventory was placed in containers and stored for some period of time or held for sale in later seasons. That action, even if it were a fact, is one essentially of business judgment. If there is more than business judgment involved, i.e., something wrongful, then plaintiffs were required under Rule 9(b) to set forth, in detail, the particulars of that wrongfulness. Plaintiffs have, instead, relied virtually exclusively on conclusory language (e.g., "inventories had *exploded to dangerously bloated levels*" (Compl. ¶ 1(a))) and hot words (e.g., "plunged into a liquidity crisis" (*id.*)) in a 111 page complaint of 138 paragraphs.

Plaintiffs allege that, by virtue of their positions, all individual defendants had access to unspecified internal corporate documents containing adverse non-public information. (Compl. ¶¶ 33(a)-(e)). Elsewhere in the complaint, plaintiffs seem to focus on three types of documents. First, plaintiffs maintain that defendants had annual budget projections and "negative internal reports" showing that these projections were not being met and that inventory was accumulating. (Compl. ¶ 40.) Second, plaintiffs claim that defendants Kasaks and Francis received weekly recaps of new store performance which revealed "serious and persistent problems with those new stores." (Compl. ¶ 41.) Finally, plaintiffs claim that Kasaks and Francis also received merchandise reports "reporting weakness in sales and mounting excess inventory." (*Id.*)

As we have noted previously, Fed. R. Civ. P. 9(b) requires that claims of fraud be pled with particularity.

Beyond this, the PSLRA requires that a complaint state "with particularity all facts" upon which allegations made upon information and belief are based. 15 U.S.C. § 78u-4(b)(1). The complaint in the instant action is woefully devoid of any such particularity. Plaintiffs acknowledge this pleading requirement in only a single paragraph:

> Plaintiffs have alleged the foregoing based upon the investigation of their counsel, which included a review of AnnTaylor's SEC filings, securities analysts reports and advisories about the Company, press releases issued by the Company, media reports about the Company and discussions with consultants, and believe that substantial evidentiary support will exist for the allegations set forth . . . .

(Compl. ¶ 138, entitled "Basis of Allegations.")

This paragraph provides none of the required facts underlying the complaint's allegations as to the information that was available to the individual defendants, nor does it direct the Court to where those facts might be found. In fact, of the possible sources listed in the paragraph, only the "consultants" could have provided plaintiffs with specifics of internal reports. If, in fact, these unnamed "consultants" provided information forming the basis for these allegations, then the consultants should have been named in the complaint.

An identical paragraph was rejected as insufficiently specific in *In re Silicon Graphics, Inc. Sec. Litig.*,

970 F. Supp. 746 (N.D. Cal. 1997). Citing to the legislative history of the PSLRA, and more specifically to an amendment rejected by Congress which would have permitted plaintiffs to plead simply facts which support their belief, the court concluded that a plaintiff might well have to provide the names of "confidential informants, employees, competitors, Government employees, members of the media, and others who have provided information leading to the filing of the case." *Id.* at 763.

Plaintiffs also provide no basis for their allegation that "[t]hroughout the Class Period, AnnTaylor was falsifying and artificially inflating its reported net income and earnings per share via its "box-and-hold" scheme to hide excess, slow-moving and/or unsalable inventory and avoid writing off that inventory." (Compl. ¶ 70(a).) Defendants allegedly moved "millions of dollars of excess and obsolete inventory from its main stores . . . to two warehouses . . . , so that AnnTaylor could avoid or delay the adverse financial statement impact of such excessive inventories." (Compl. ¶ 70(j).)

At oral argument before this Court on November 17, 1997, plaintiffs maintained that they had conducted a one-year investigation into this alleged scheme, and that in the course of this investigation, they had spoken to former employees of AnnTaylor. They also maintained that written documentation of the scheme exists, and that AnnTaylor documents actually use the phrase "box-and-hold." (Tr. at 58-59.) If plaintiffs do, in fact, have this sort of information available to them, then it should have been included in the complaint. Oral, unsworn representations made by counsel

cannot substitute for formal pleadings or affidavits. *See San Leandro Emergency Med. Group v. Philip Morris Cos.*, 75 F.3d 801, 808 (2d Cir. 1996) (stating that plaintiffs' unsupported claim of the existence of confidential company reports is insufficient to survive a motion to dismiss, and citing with approval cases from the First and Seventh Circuits requiring that plaintiffs provide specifics as to internal reports).

The Court rejects as inconsistent with the pleading requirements of the PSLRA plaintiffs' allegations regarding a "box-and-hold" scheme. We note briefly that counsel for the AnnTaylor defendants stated at oral argument that AnnTaylor does, in fact, transfer merchandise to warehouses on a seasonal basis, that some of this merchandise is ultimately sold at less than full price, and that the value of this inventory is written down on the books as markdowns are taken. (Tr. at 23-27.) Plaintiffs allege that by January 29, 1994, AnnTaylor had hidden approximately $6 million in inventory and failed to take corresponding write-offs of $3.25 million, and that by January 28, 1995, approximately $25 million worth of inventory was hidden, requiring write downs in excess of approximately $10 million. (Compl. ¶¶ 109, 119, 123.) Because plaintiffs offer no facts upon which they base their allegations, they are improperly pled.[6]

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6. On this motion to dismiss, the Court does not, of course, gauge the credibility of plaintiffs' allegations in regard to a "box-and-hold" scheme. We note, however, that defendant Francis, the Chief Financial Officer of AnnTaylor, who is alleged to have been "hand-picked for his job with AnnTaylor by Merrill Lynch so that Merrill Lynch would be able to manipulate AnnTaylor's

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More to the point, however, is the import to be accorded plaintiffs' data, even were we to accept them. AnnTaylor acknowledges holding merchandise in warehouses and ultimately marking down this merchandise. Plaintiffs, without specifying precisely when or under what circumstances markdowns should have been made, apparently fault the timing of the markdowns that were made.[7] But disagreement with a company's business judgment does not state a claim under federal securities laws. *See In re Software Toolworks, Inc. Sec. Litig.*, 789 F. Supp. 1489, 1504 (N.D. Cal. 1992) ("[W]hether the inventory should have been written down was a matter of judgment on which Plaintiffs disagree, not a basis on which to infer scienter."), *aff'd in part, rev'd in part on other grounds*, 50 F.3d 615 (9th Cir. 1994). To hold otherwise, absent specific factual information as required by Rule 9(b), would be to expose every inventory judgment of a reporting company to the potential burden of litigation.

In sum, the Court finds that plaintiffs have properly pled nothing more than that the AnnTaylor defendants issued a

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financial results" (Compl. ¶ 33(b)), *bought* 16,000 shares of AnnTaylor stock, at prices ranging from $31.675 to $41.625, during the period when it is alleged that the Merrill Lynch defendants benefited from his wrongful conduct by *selling* portions of the shares held by them.

7. Plaintiffs also attribute ulterior motives to the timing of the markdowns. Plaintiffs' failure to point to a factual source for their allegations leads the Court to regard such allegations as mere surmise.

series of positive statements about the financial health of the company, that certain securities analysts utilized these statements in forming an opinion about the prospects of the company, that opinions issued by these analysts led to a rise in the share price of AnnTaylor stock, and that this share price fell when AnnTaylor subsequently issued negative statements. The remainder of plaintiffs' allegations in regard to scienter are unsupported by any sort of factual background, and we must disregard them as speculation. *See In re 1993 Corning Sec. Litig.*, 1996 WL 257603, at *8 (S.D.N.Y. May 15, 1996) (dismissing complaint which "simply 'couple[d] a factual statement with a conclusory allegation of fraudulent intent.' ") (quoting *Shields v. Citytrust Bancorp., Inc.*, 25 F.3d 1124, 1129 (2d Cir. 1994)).

The Court's finding that the AnnTaylor defendants lacked the requisite scienter under the PSLRA is dispositive, not only of the claims against them, but also of the Section 10(b) and Rule 10b-5 claims against defendants Burke and Armstrong, and the corporate Merrill Lynch defendants. The complaint alleges nothing more than that Burke and Armstrong were outside directors of AnnTaylor,[8] and had

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8. Plaintiffs argue that Armstrong and Burke "were intimately involved in AnnTaylor day-to-day operations" (Mem. in Opp'n to Merrill Lynch Mot. to Dismiss at 19), and should therefore be treated not as outside directors, but rather as corporate insiders. *See Hallet v. Li & Fung, Ltd.*, No. 95-Civ.-8917, 1996 U.S. Dist. LEXIS 12513 at *9-12 (S.D.N.Y. Aug. 27, 1996) (stating that outside directors may be considered insiders when they have access to a certain class of information). This distinction is irrelevant to our analysis, and we decline to decide it. There is no allegation in the complaint that

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access to the same documents as did the AnnTaylor defendants. When given the opportunity at oral argument to present to the Court particulars as to Armstrong's and Burke's actual knowledge at any given point in time, and as to whether Armstrong and Burke communicated this knowledge to the other Merrill Lynch defendants, counsel for plaintiffs was unable or unwilling to provide such detail.

> THE COURT: They [Armstrong and Burke] specifically knew of this box-and-hold scheme? Are you alleging that?
>
> MR. FLEISCHMAN: Your Honor, it is alleged that they had knowledge, yes, of everything internally that was going on, which would include the box-and-hold scheme.
>
> THE COURT: By reference to what do you tell me that this is so? In other words, Rule 9(b) has certain parameters, and the Act certainly incorporates those parameters; that is, where, when, under what circumstances did they acquire this knowledge of a box-and-hold scheme, not that inventory was going up and down or that sales were going up and down in particular stores. How do you know this?

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Armstrong and Burke had access to information not available to the AnnTaylor defendants, and so allegations of scienter on the part of Armstrong and Burke are also insufficiently pled.

MR. FLEISCHMAN: Well, first of all, we don't have to know that for the pleading of a complaint. We don't have to say in the complaint that Armstrong and Burke sat in on a meeting where the box-and-hold was discussed. It is enough to say that they are insiders with material inside information about the company, and we can make reasonable inferences from who they are. The law allows us to do that. . . .

* * *

THE COURT: I want, please, to focus in on something specific, and that is, are you saying that there were internal corporate documents which referred to a box-and-hold scheme and were known to Armstrong and Burke? You said "all internal documents."

MR. FLEISCHMAN: You are asking me —

THE COURT: I am asking you a very simple question.

MR. FLEISCHMAN: You are asking an evidence question that is outside of the complaint.

THE COURT: The truth is, I have asked everybody evidence questions that are outside the complaint. I am asking you this question.

MR. FLEISCHMAN: I am telling you that — to make the representation — I don't want to give our hand away as to our investigation in this case. I don't think it is appropriate in this courtroom and in this setting for the sufficiency of this pleading to do so. But the short answer to your question is that Armstrong and Burke had available to them —

THE COURT: Had available because of their positions you are saying?

MR. FLEISCHMAN: Yes.

THE COURT: My question goes beyond that. My question is: Did they have actual knowledge? Did they operate with reckless conduct such as I have described?

MR. FLEISCHMAN: I think that the complaint alleges that sufficiently. It alleges that they had knowledge of all the internal information which would include the box-and-hold scheme.

* * *

THE COURT: In effect, they knew in January 1994 of the, quote, box-and-hold scheme, correct?

MR. FLEISCHMAN: That is what the complaint alleges.

THE COURT: I am saying to you, did they know it because they saw memoranda that referred to a box-and-hold scheme or did they know it because they were generally reviewing internal financial materials that referred to the status of inventory?

MR. FLEISCHMAN: You may infer from the allegations in the complaint that since they saw all of the internal documents, internal financial documents, as it is recited in the complaint, that they knew of the box-and-hold scheme, that they knew of the warehouse, that they knew everything about it. You may infer that from the complaint, yes.

THE COURT: In fact, you have told me that there were documents that referred to a box-and-hold scheme.

MR. FLEISCHMAN: I have made that representation to the court.

THE COURT: My question to you now is, did they see those documents?

MR. FLEISCHMAN: There is no requirement, your Honor —

THE COURT: I didn't ask you that.

MR. FLEISCHMAN: — under the law.

THE COURT: I am not asking you about requirements. I am asking you the fact. Did they know it? Did they see it?

MR. FLEISCHMAN: As I stand here today before you, your Honor, I can't answer that question.

* * *

THE COURT: You have four insiders [former employees of AnnTaylor] who apparently have given you some information and you apparently are telling me you are not just relying on the prospectus, the 10K, the 10Q, you are relying on more than that. You have conducted a year-long investigation, and I appreciate that. I am asking you now, can you answer this question: Did Armstrong and Burke communicate the fact of the inventory problem and the need for Ann Taylor to have written this off to any of the other defendants? Did they? I am not asking you what the requirement was.

MR. FLEISCHMAN: The answer is, if I knew the answer, your Honor, I don't know that I would be so forthcoming to tell you at this stage of the litigation, but the answer is, I don't know and I don't have to know.

(Tr. at 74-75, 77-78, 85-86, 87.)

Appendix C

In signing the complaint, plaintiffs' counsel represented to the Court that he had conducted a reasonable inquiry into the facts underlying this action. *See* Fed. R. Civ. P. 11(b). Despite this inquiry, counsel could not tell the Court whether Armstrong and Burke had ever seen documents or been informed of anything relating to a box-and-hold scheme or whether they had communicated such information to the corporate Merrill Lynch defendants. The complaint's allegations as to scienter on the part of any of the Merrill Lynch defendants, including Armstrong and Burke, are thus not pled with the particularity required by the PSLRA, nor supported by an adequate factual background.

We turn finally to the allegations brought under Section 20 of the 1934 Act[9] that various defendants are liable as control persons or control groups.[10] The Court is unable from the complaint alone to define the basis for these claims against defendants Kasaks, Armstrong, Burke, and AnnTaylor, and so we focus on those against "Merrill Lynch." In order to establish a claim for control person liability under Section 20, plaintiffs must establish (1) a primary violation of the 1934 Act, (2) control of the primary

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9. This section states, in relevant part, that "[e]very person who, directly or indirectly, controls any person liable under any provision of this chapter . . . shall also be liable jointly and severally with and to the same extent as such controlled person . . . ." 15 U.S.C. § 78t(a).

10. Plaintiffs allege that defendants Kasaks, Armstrong and Burke controlled AnnTaylor, and that AnnTaylor controlled them. (Compl. ¶ 135.) Plaintiffs also allege that "Merrill Lynch" controlled Armstrong and Burke, and therefore also controlled AnnTaylor, Kasaks, and Francis. (Compl. ¶ 136.)

violator by the defendant, and (3) the defendant's culpability in the fraud perpetrated by the controlled person. *See Securities & Exchange Comm'n v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996). First, as the Court has found, plaintiffs have failed properly to plead a violation of the 1934 Act. Second, as we also have noted, plaintiffs have failed properly to allege scienter and/or culpability on the part of "Merrill Lynch." Even had we found a properly pled violation of the 1934 Act, we would not automatically impute this violation to "Merrill Lynch" as a controlling entity. *See Baesa*, 969 F. Supp. at 242 ("[T]he law in this circuit is clear that a subsidiary's fraud cannot be automatically imputed to its corporate parent."). *See also Chill v. General Elec. Co.*, 101 F.3d 263, 270 (2d Cir. 1996) (holding that a parent company would, at the very least, have to have been deliberately blind to its subsidiary's fraud in order to have the requisite scienter).

In sum, the Court finds that the absence of adequate allegations of scienter in the complaint is fatal to plaintiffs' claims under Section 10(b) of the 1934 Act and Rule 10b-5, and that plaintiffs have failed to meet the minimal requirements to plead control person liability. The complaint will be dismissed.

CONCLUSION

For the reasons set forth above, defendants' motions to dismiss the complaint under Fed. R. Civ. P. 12(b)(6) and Section 21D(b)(3) of the 1934 Act are granted. The complaint is dismissed. Plaintiffs are hereby granted leave, within thirty days of the date of this Opinion and Order, to amend and

re-file the complaint. In the event of such a filing, counsel for the parties are directed to jointly telephone Chambers to schedule further proceedings herein.

SO ORDERED.

Dated: New York, New York
March 10, 1998

s/ Allen G. Schwartz
ALLEN G. SCHWARTZ, U.S.D.J.